China: Overnight SHIBOR hit historical high after jumping by 578bps

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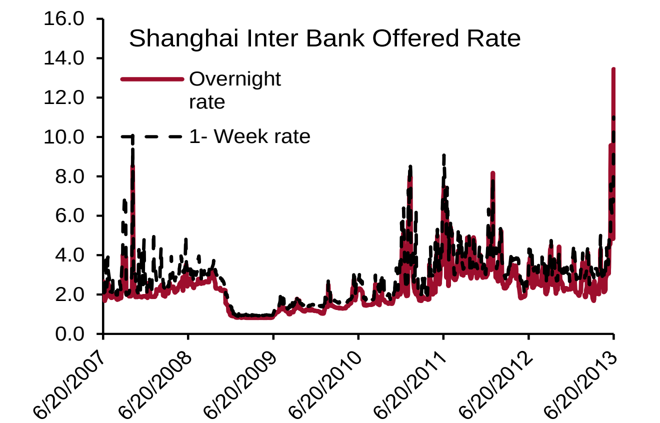
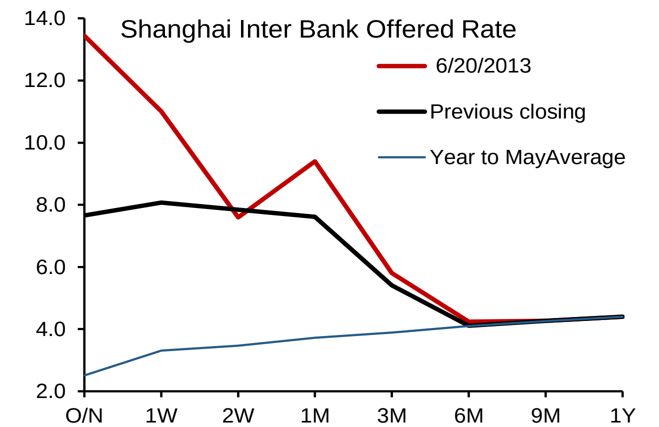
- The overnight SHIBOR rate jumped by 578bps to hit 13.4% on 20 June, its highest on record. The PBoC issued another RMB 2bn in bills to withdraw liquidity on Tuesday on top of the RMB 2bn issued the same day.
- This withdrawal of RMB4bn is small and negligible, but the message from the central bank is very significant. The PBoC has made it clear that it intends to penalize those aggressive lenders and to crack down on the potential for moral hazard. The central bank decided not to inject additional liquidity for emergency need. It seemed to shrug off the pressure from the banks asking for a lower reserve requirement ratio. To us, this is a sign of brinksmanship.
- This wrestling, in our view, has heightened the systemic risk in the financial system, creating policy uncertainty and further induced market volatility. By allowing the overnight SHIBOR to spike again, the market has a legitimate reason to ask whether the central bank has the will and ability to calm the interbank market.
- The length matters a lot more than the height of the rate spikes in the interbank market. The longer this lasts, the more likely that some banks may face serious liquidity trouble and that would further undermine the creditability between banks, creating a chain reaction.
- It is our view that draining interbank liquidity at the interbank market could cause unintended consequences, at a time at which duration and risk mismatch among the banks are severe, account receivables in the corporate sector are surging, and the inflow of FX reserves is decelerating sharply. We consider this a tail risk, but we believe it would be useful to highlight channels that could trigger systemic risk: (1) a freeze in corporate lending market, leading to corporate cash flow trouble, (2) much weakened WMP sales, causing local government payment failure in rolling over their debt, (3) one or two bank failures, leading to a freeze in the interbank market, and (4) a potential bank run, creating panic at the retail level.

Exhibit 1: Both overnight and one-week SHIBOR hit historical high



Source: SHIBOR.Org, Credit Suisse

Exhibit 2: Short-term rates stayed elevated, three-month rate increased as well

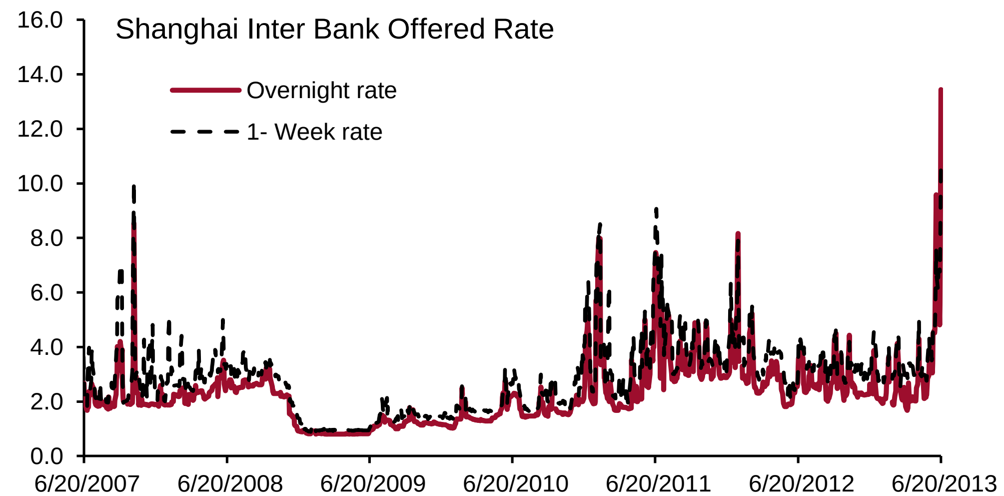


Source: SHIBOR.Org, Credit Suisse

Overnight SHIBOR jumped to historical high

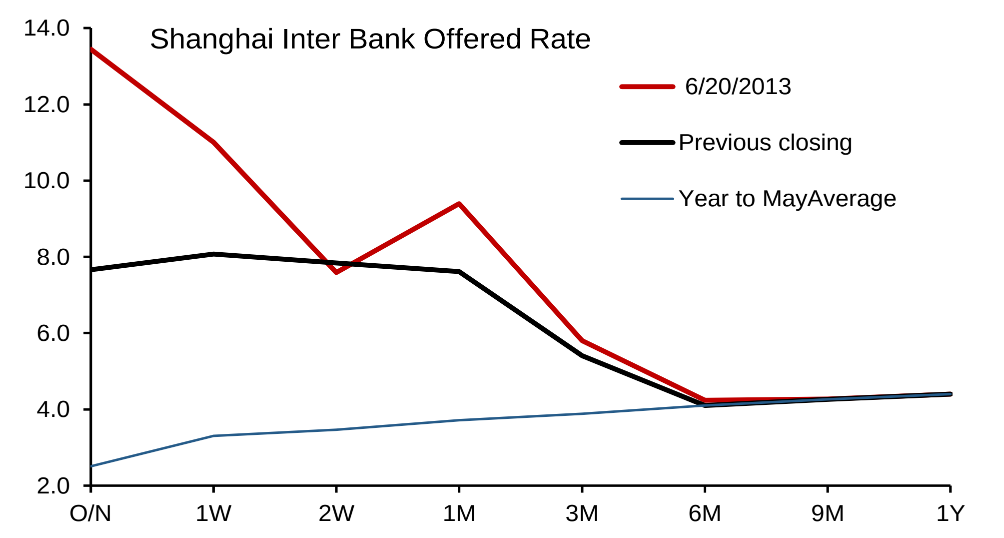
The overnight SHIBOR rate jumped by 578bps to hit 13.4% on 20 June, its highest on record. The one-week rate also hit its historical high at 11.0%, after seeing a sharp increase of 292.9bps from its prior high of 8.08%. The two-week rate moved down slightly by 24.5bps to 7.59%; however, a substantial increase of 178bps was observed at the one-month rate. The three-month and six-month rates, which hardly moved, also shifted upward by 39.5bps and 13.9bps, respectively, despite nine-month and one-year rates remaining stable.

Exhibit 3: Both overnight and one-week SHIBOR hit historical high



Source: SHIBOR.Org, Credit Suisse

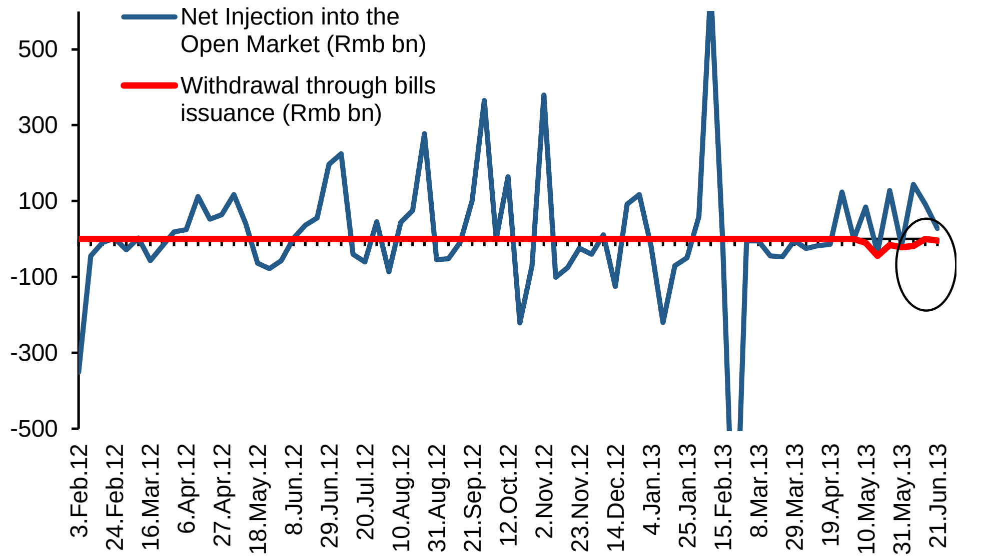
Exhibit 4: Short-term rates stayed elevated, three-month rate increased as well



Source: SHIBOR.Org, Credit Suisse

Small size bill issuance sent significant message from the central bank

Exhibit 5: Almost negligible bill issuance sent clear message from the PBoC



Source: PBoC, Credit Suisse

The PBoC, issued another RMB 2bn bills to withdraw liquidity from the interbank market today on top of the RMB 2bn issued on Tuesday. Together with the matured bills of RMB 18bn and the matured repos of RMB 14bn, the weekly net liquidity injection came in at RMB 28bn, less than the RMB 92bn seen in the previous week. The central bank has also auctioned out RMB 40bn of treasury deposit with a six-month maturity through its treasury cash management system. News flow reported that the big four banks were hoping for an RRR cut from the PBoC on Wednesday night; however, their anticipated cut was not realized.

The net withdrawal of RMB4bn over two occasions is small and negligible, but the message from the central bank is very significant, in our view. The monetary authority has made it clear that it intends to penalize those aggressive lenders and to crack down on the potential for moral hazard. Some small/medium-sized banks have deployed an excessive amount of liquidity into high yield/high risk assets, including corporate bonds issued by LGFVs that ratings agents warned about commercial viability and credit risk, counting on the central bank's rescue in the case that liquidity gets tightened. The PBoC decided not to inject additional liquidity for emergency need. The central bank seemed to shrug off the pressure from the banks asking for a lower reserve requirement ratio. To us, this is a sign of brinksmanship.

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This wrestling, in our view, has heightened the systemic risk in the financial system, creating policy uncertainty and further induced market volatility. By allowing the overnight SHIBOR to spike again, the market has a legitimate reason to ask whether the central bank has the will and ability to calm the interbank market which for us brings back the memory of the US government allowing Lehman Brothers to fail.

We have a few observations to offer. (1) SHIBOR hikes, or even bank failure in settling within the interbank market, happened before, with the latest events in 2011 and 2012. (2) There appears to be no bank run at the retail level, as depositors seem calm, at least for now. (3) The liquidity crunch has occurred at the interbank market due to the duration mismatch and the lack of policy response, but so far neither has affected the real economy – large SOEs still remain cash rich while SMEs are struggling with liquidity. (4) How soon the turbulence can be resolved rests on the will of the central bank. (5) We believe that the State Council has the authority to stop this brinksmanship and probably has the political will to do so, should the situation go too far, but whether the decision makers can make a sound judgment on when is "too far," only time can tell.

The length matters a lot more than the height of the rate spikes in the interbank market. We believe the elevated SHIBOR has not reached its end. The longer this lasts, the more likely that some banks may face serious liquidity trouble and that would further undermine the creditability between banks, creating a chain reaction. It is our view that draining interbank liquidity at the interbank market could cause unintended consequences, at a time at which duration and risk mismatch among the banks are severe, account receivables in the corporate sector are surging, and the inflow of FX reserves is decelerating sharply.

We consider this a tail risk, but it would be useful to highlight channels that could trigger systemic risk: (1) a freeze in corporate lending market, leading to corporate cash flow trouble, (2) much weakened WMP sales causing local government payment failure in rolling over their debt, (3) one or two bank failures, leading to a freeze in the interbank market, and (4) a bank run, creating panic at the retail level.

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Disclosure Appendix

Analyst Certification

I, Dong Tao and Weishen Deng, certify that (1) the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.