

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

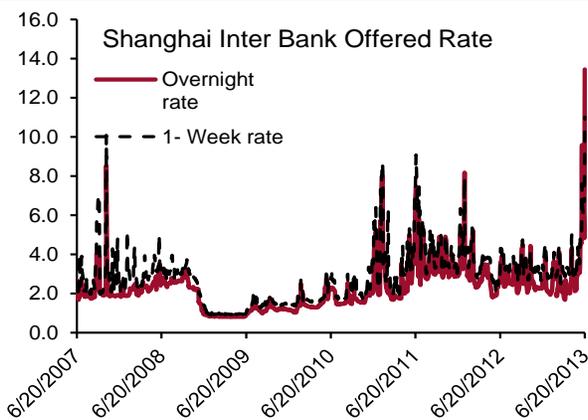
Research Analysts

Dong Tao
 +852 2101 7469
dong.tao@credit-suisse.com

Weishen Deng
 +852 2101 7162
weishen.deng@credit-suisse.com

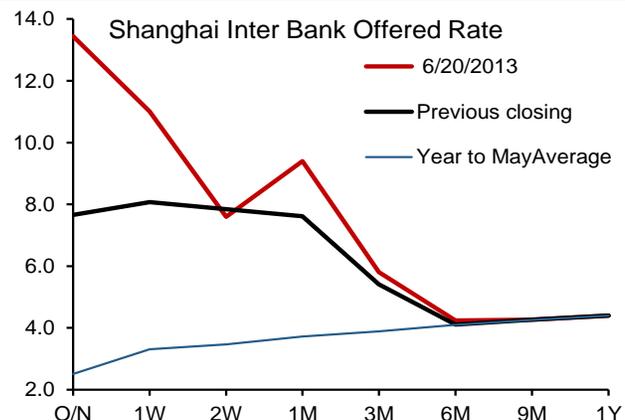
- The overnight SHIBOR rate jumped by 578bps to hit 13.4% on 20 June, its highest on record. The PBoC issued another RMB 2bn in bills to withdraw liquidity on Tuesday on top of the RMB 2bn issued the same day.
- This withdrawal of RMB4bn is small and negligible, but the message from the central bank 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

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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

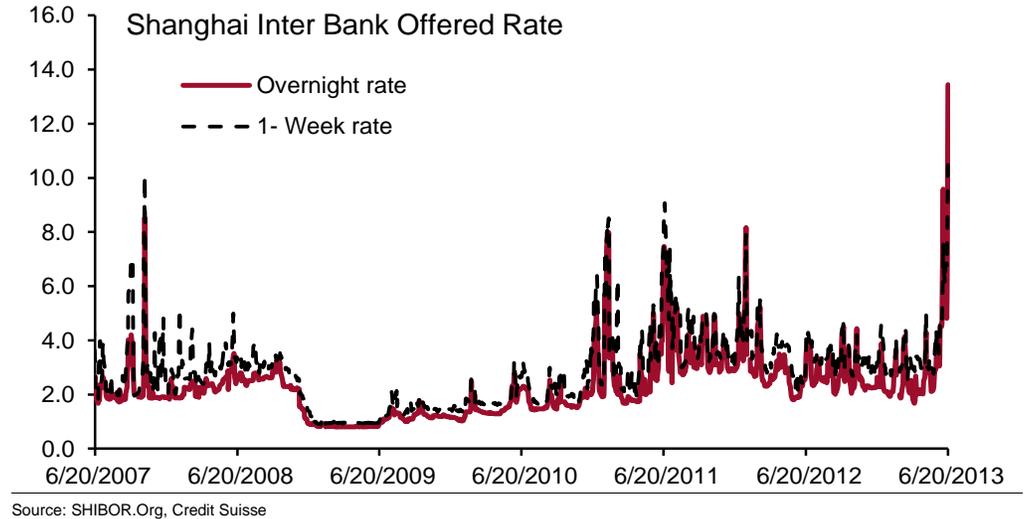
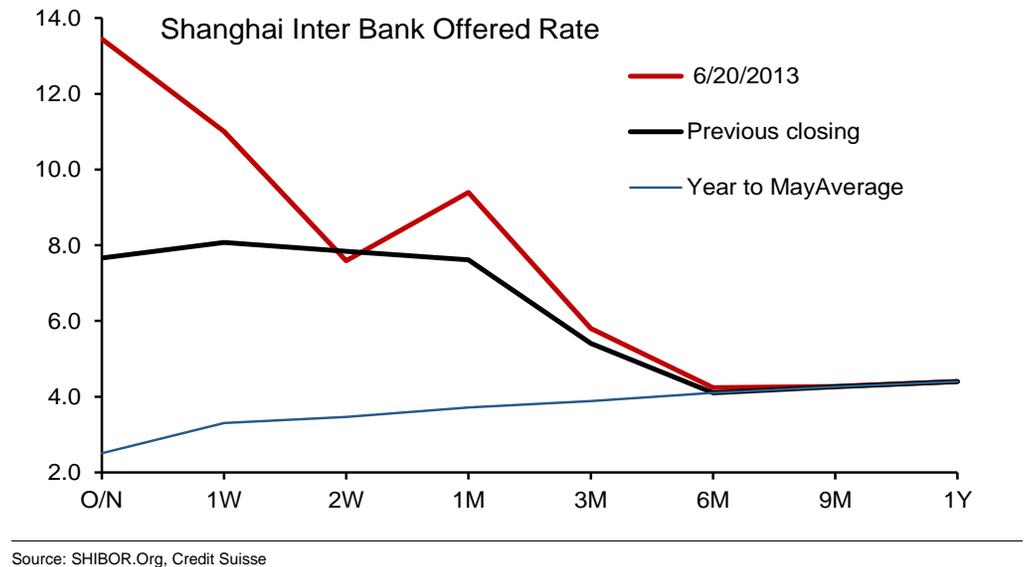
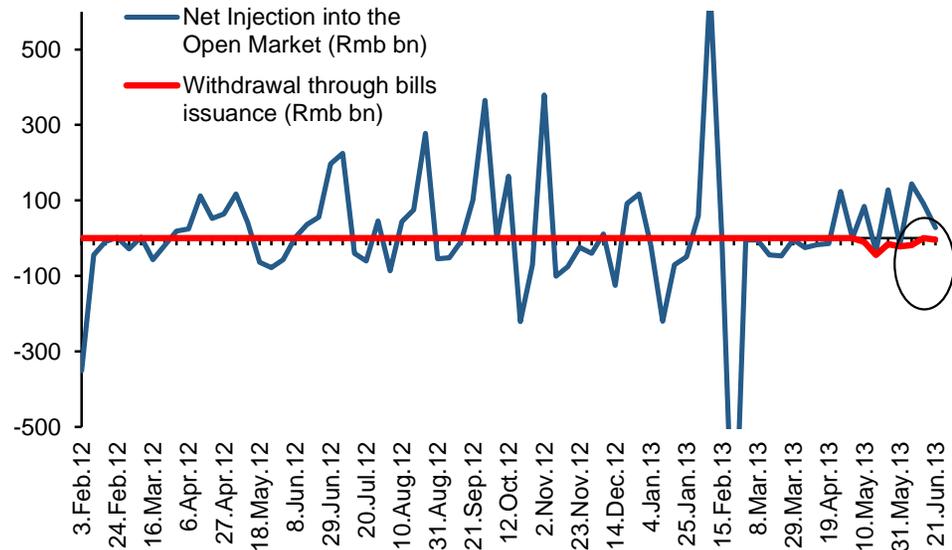


Exhibit 4: Short-term rates stayed elevated, three-month rate increased as well



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 brinkmanship.

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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 brinkmanship 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.

GLOBAL FIXED INCOME AND ECONOMIC RESEARCH

Dr. Neal Soss, Managing Director
Chief Economist and Global Head of Economic Research
+1 212 325 3335
neal.soss@credit-suisse.com

Eric Miller, Managing Director
Global Head of Fixed Income and Economic Research
+1 212 538 6480
eric.miller.3@credit-suisse.com

US AND CANADA ECONOMICS

Dr. Neal Soss, Managing Director
Head of US Economics
+1 212 325 3335
neal.soss@credit-suisse.com

Jonathan Basile, Director
+1 212 538 1436
jonathan.basile@credit-suisse.com

Jay Feldman, Director
+1 212 325 7634
jay.feldman@credit-suisse.com

Henry Mo, Director
+1 212 538 0327
henry.mo@credit-suisse.com

Dana Saporta, Director
+1 212 538 3163
dana.saporta@credit-suisse.com

Jill Brown, Vice President
+1 212 325 1578
jill.brown@credit-suisse.com

Isaac Lebwohl, Associate
+1 212 538 1906
isaac.lebwohl@credit-suisse.com

Peggy Riordan, AVP
+1 212 325 7525
peggy.riordan@credit-suisse.com

LATIN AMERICA ECONOMICS AND STRATEGY

Alonso Cervera, Managing Director
Head of Non-Brazil Latam Economics
+52 55 5283 3845
alonso.cervera@credit-suisse.com
Mexico, Chile

Casey Reckman, Vice President
+1 212 325 5570
casey.reckman@credit-suisse.com
Argentina, Venezuela

Daniel Chodos, Vice President
+1 212 325 7708
daniel.chodos@credit-suisse.com
Colombia, Latam Strategy

Di Fu, Analyst
+1 212 538 4125
di.fu@credit-suisse.com

Nilson Teixeira, Managing Director
Head of Brazil Economics
+55 11 3701 6288
nilson.teixeira@credit-suisse.com

Daniel Lavarda, Vice President
+55 11 3701 6352
daniel.lavarda@credit-suisse.com
Brazil

Iana Ferrao, Associate
+55 11 3701 6345
iana.ferrao@credit-suisse.com
Brazil

Leonardo Fonseca, Associate
+55 11 3701 6348
leonardo.fonseca@credit-suisse.com
Brazil

Paulo Coutinho, Associate
+55 11 3701-6353
paulo.coutinho@credit-suisse.com
Brazil

EURO AREA AND UK ECONOMICS

Neville Hill, Managing Director
Head of European Economics
+44 20 7888 1334
neville.hill@credit-suisse.com

Christel Aranda-Hassel, Director
+44 20 7888 1383
christel.aranda-hassel@credit-suisse.com

Giovanni Zanni, Director
+44 20 7888 6827
giovanni.zanni@credit-suisse.com

Violante di Canossa, Vice President
+44 20 7883 4192
violante.dicanossa@credit-suisse.com

Axel Lang, Associate
+44 20 7883 3738
axel.lang@credit-suisse.com

Steven Bryce, Analyst
+44 20 7883 7360
steven.bryce@credit-suisse.com

Yiagos Alexopoulos, Analyst
+44 20 7888 7536
yiagos.alexopoulos@credit-suisse.com

EASTERN EUROPE, MIDDLE EAST & AFRICA ECONOMICS AND STRATEGY

Berna Bayazitoglu, Managing Director
Head of EEMEA Economics
+44 20 7883 3431
berna.bayazitoglu@credit-suisse.com
Turkey

Sergei Voloboev, Director
+44 20 7888 3694
sergei.voloboev@credit-suisse.com
Russia, Ukraine, Kazakhstan

Carlos Teixeira, Director
+27 11 012 8054
carlos.teixeira@credit-suisse.com
South Africa

Gergely Hudecz, Vice President
+33 1 7039 0103
gergely.hudecz@credit-suisse.com
Czech Republic, Hungary, Poland

Alexey Pogorelov, Vice President
+7 495 967 8772
alexey.pogorelov@credit-suisse.com
Russia, Ukraine, Kazakhstan

Shahzad Hasan, Vice President
+1 212 325 2003
shahzad.hasan@credit-suisse.com
EEMEA Strategy

Natig Mustafayev, Associate
+44 20 7888 1065
natig.mustafayev@credit-suisse.com
EM and EEMEA cross-country analysis

Nimrod Mevorach, Associate
+44 20 7888 1257
nimrod.mevorach@credit-suisse.com
EEMEA Strategy, Israel

JAPAN ECONOMICS AND STRATEGY

Hirokichi Shirakawa, Managing Director
+81 3 4550 7117
hirokichi.shirakawa@credit-suisse.com

Takashi Shiono, Associate
+81 3 4550 7189
takashi.shiono@credit-suisse.com

Tomohiro Miyasaka, Director
+81 3 4550 7171
tomohiro.miyasaka@credit-suisse.com

NON-JAPAN ASIA ECONOMICS

Dong Tao, Managing Director
Head of NJA Economics
+852 2101 7469
dong.tao@credit-suisse.com
China

Robert Prior-Wandesforde, Director
+65 6212 3707
robert.priorwandesforde@credit-suisse.com
Regional, India, Indonesia, Australia

Christiaan Tuntono, Vice President
+852 2101 7409
christiaan.tuntono@credit-suisse.com
Hong Kong, Korea, Taiwan

Santitarn Sathirathai, Vice President
+65 6212 5675
santitarn.sathirathai@credit-suisse.com
Regional, Malaysia, Thailand

Michael Wan, Analyst
+65 6212 3418
michael.wan@credit-suisse.com
Singapore, Philippines

Weishen Deng, Analyst
+852 2101 7162
weishen.deng@credit-suisse.com
China

Disclosure Appendix

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