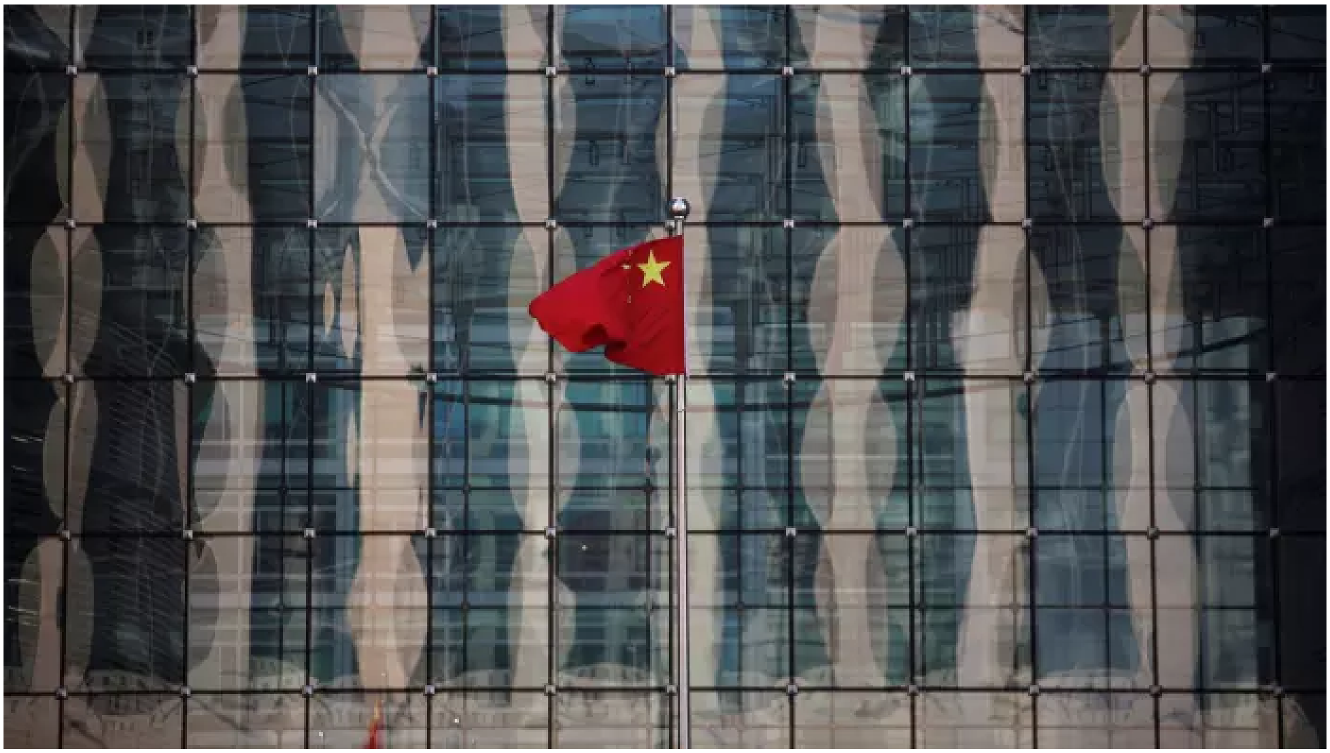
People's Bank of China

Central bank injection soothes China credit squeeze

Despite added liquidity, analysts sceptical PBoC can counter capital outflows effect



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DECEMBER 16, 2016 by: **Yuan Yang** and **Tom Mitchell** in Beijing

China's central bank took steps on Friday to ease a credit squeeze that has been exacerbated by the US Federal Reserve's rate increase (http://next.ft.com/content/c99ee660-c219-11e6-81c2-f57d90f6741a).

The People's Bank of China injected a net Rmb45bn ($6.5bn) into the interbank market through reverse repos, bringing total net injections for the week to Rmb250bn. This marked a reversal from last week when the central bank drained more than Rmb500bn from the market.

The central bank also injected Rmb394bn into the interbank market on Friday using its medium-term lending facility. This month it pumped Rmb721bn in 3-month loans using this facility, an all-time high according to data from NSBO, a China policy research firm.

"The vast scale of these injections shows that the PBoC is acknowledging the need to do something about very tight liquidity," said Jonas Short at NSBO. "Long-term rates have been shooting up and it's been choking liquidity in the bond markets."

The yield on the Chinese government's ten-year bond rose slightly to 3.33 per cent on Friday. Despite the PBoC's injections, some analysts say it cannot fully counteract the effect of capital outflows.

China's financial markets have been tightly squeezed this week, with the overnight Shibor rate — which reflects the difficulty of financing loans in China — hitting a 20-month high of 2.33 per cent on Friday, according to data from Wind.

"The PBoC's monetary stance has been held hostage by its foreign exchange management," said Chi Lo at BNP Paribas. "The cost of this foreign exchange stability is a passive tightening of liquidity which the PBoC's open market operations has not been able to totally offset."

The central bank has been selling down its foreign exchange holdings in an effort to slow the renminbi's fall against the dollar and stem capital outflows (http://next.ft.com/content/078ad2fa-c28c-11e6-9bca-2b93a6856354). Both the PBoC's dollar sales and continued capital outflows have drained liquidity from the bond market, which has rallied strongly over the past 18 months.

Before the Fed's rate increase on Wednesday, the PBoC had appeared to be taking advantage of outflows to squeeze leverage out of the market without raising borrowing costs in the real economy.

Mr Short said the bond market had become "ground zero" for the PBoC's tightening campaign over recent months, which has threatened to end Chinese bonds' long bull run.

"The pressure on [China's] bond markets is likely to intensify," he added. "Borrowing costs for nonbank financial institutions are rising sharply and this is forcing them to sell off these bonds."

Separately on Friday, China's banking regulator ordered banks to stop supporting "zombie" companies in the coal and steel sectors. Both industries have been buoyed by rising prices over recent months, frustrating authorities' larger effort to reduce overcapacity.

On Thursday, the day after the Fed's interest rate rise, sharp price drops in five- and 10-year China government bond futures triggered an automatic trading halt — a temporary suspension similar to the "circuit breaker" mechanisms that occasionally stop trading on the country's equity markets.

Chinese government bond yields, which rise as prices fall, also hit a 15-month high on Thursday, according to data from ChinaBond.

The PBoC's move to inject liquidity corresponded with official data from the US Treasury showing that Tokyo had surpassed Beijing as Washington's top creditor (http://next.ft.com/content/9b46cd46-c336-11e6-9bca-2b93a6856354) in October, largely as a result of China's efforts to support the renminbi.

Eswar Prasad, a China financial expert at Cornell University, said the development marked a "stark reversal of fortunes" for the world's second-largest economy. "The PBoC's attempts to stabilise the renminbi-dollar exchange rate in the face of persistent capital outflows continue to drain its stock of [foreign exchange] reserves."

Additional reporting by Gabriel Wildau in Shanghai
