**Mizuho Insights**

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**AXJ FX: Caution on Chinese liquidity headwinds**

- **China is entering into a leverage-control cycle.** This is evident from increased regulations and a sustained period of tight liquidity conditions, even as the PBoC has sporadically acted to temper excessive jumps in money market rates.

- **Current de-risking efforts could be linked with China’s political cycle.** We think policymakers are aiming to rein in major financial risks before the Communist leadership reshuffle due later this year, allowing the new leadership to inherit an economy that has undergone significant risk reduction.

- **For now, there has been neither a significant paring of “shadow banking” assets, nor major credit events that highlight extreme stresses.** As such, policymakers could keep liquidity conditions tight for an extended period to prod more de-risking, while staying suitably tempered to prevent an outsized growth disruption.

- **Tight Chinese liquidity conditions could in turn pose headwinds to AXJ FX via two key channels,** namely by 1/ crimping commodity sentiment and commodity-linked currencies (AUD), and also by 2/ raising risks of an export slowdown for trade-dependent Asian economies (MYR, SGD).

**China’s policy shift towards financial stability**

With receding economic risks in China amidst stronger growth (Q1: +6.9% YoY), Chinese policymakers have shifted their policy priorities from stimulating growth, towards safeguarding financial stability and deflating a potential credit bubble. This has entailed a clamp-down of the fast-expanding “shadow banking” sector through a dual-pronged approach, with 1/ a regulatory crackdown and 2/ a measured tightening of monetary/liquidity settings.

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An emphasis on financial stability is evident from the fact that such de-risking efforts are now led by senior Party members rather than bureaucrats as in the past. In a top-level Politburo meeting chaired by Xi Jinping on 25 April, discussions on the economic agenda were reportedly centred on promoting structural reforms, in addition to curbing financial risk via increased regulatory co-ordination and heavier penalties on rule violations.

Indeed, CBRC (China Banking Regulatory Commission) Chairman Guo Shuqing, who was just appointed this year, has been quick off the bat in tackling banking system risks, vowing to clean up “chaos” in the banking regulatory system. The CBRC has already introduced a slew of new rules on wealth management products (WMP) in April, with more rule changes in the pipeline. The bank regulator also launched emergency risk assessments of banks’ new business practices, seemingly in conjunction with the securities regulator (CSRC) and insurance regulator (CIRC), which are both moving forward on reforms to enhance market stability.

These regulatory efforts are complemented by the PBoC, which has tightened liquidity conditions and driven up money market rates since late 2016. This was done by refraining from injecting excessive liquidity, even as significant amount of MLF (medium-term lending facility) funds mature this year. With WMP often providing leveraged returns by tapping interbank funding, a spike in money market rates is directly targeted at crimping issuance and encouraging a deleveraging of existing products. A higher rate environment is also reflective of a broader adjustment in the context of Fed normalization, especially given lingering concerns that capital outflow pressures could revive.

Tighter liquidity conditions are reflected not just in money markets (i.e. 7d repo rates), but also in sharp increases across the CGB yield curve (see Figure 1). Last week’s average 2Y yield of 3.63% marks a lofty 2½ year high - a steep jump (+64bps) from end Q1 levels.

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**Figure 1. MM rates and CGB yields have risen**

**Figure 2. Composition of New Aggregate Financing**

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Sources: Reuters, Mizuho Bank
Balancing between deleveraging and growth

Non-traditional lending (WMPs, entrusted loans, etc) is now more prominent and has seen an increased share of new aggregate financing in recent years (see Figure 2). While this reflects product innovation and more efficient financial intermediation, regulatory oversight has struggled to catch up. Much of these new-fangled lending are off-balance sheet (with credit risks still residing with the banks), so the economic leverage of banks are far higher than that reported in the accounting format to regulators. These had stirred fears of a “credit bubble” that has developed under the radar of policymakers, so current efforts aim to remedial this situation by encouraging deleveraging (see Box 1 for definition) and de-risking in the “shadow banking” sector.

Box 1. “Deleveraging” in the Chinese Context

Reading Chinese official documents, it is hard to escape the conclusion that “Deleveraging” has emerged as a key policy objective, alongside “Bubble Suppression” and “Risk Control”. The “Deleverage” term appears 10 times in PBoC’s Q1 2017 monetary policy report, which is three times more than the 2015-2016 average frequency. The policy shift towards prodding deleveraging cannot be mistaken, but what does it actually mean?

We do not think it implies shrinking the stock of credit, as this entails benchmark lending rate hikes as well. Rather, a slowing of credit growth below that of nominal GDP growth is closer to what China intends as “deleveraging”. There is another special qualitative dimension, which is to beat back the economic leverage of banks to the accounting leverage level sanctioned by regulators, via suppressing shadow banking.

Standard Chinese loans are pegged to administered lending rates, as compared to non-traditional financing which are typically priced off interbank rates. Thus, engineering a money market squeeze is positive discrimination, immunizing standard loans but crimping the profitability of “shadow lending”. However, the shadow sector’s much larger size now give rise to concerns that money market rates could be too blunt an instrument to curb risks, given the potential for larger spillovers to real economy and asset prices.
Indeed, recent data have pointed to **easing Chinese growth momentum after the Q1 pickup.** April’s manufacturing PMI came in at its lowest level in 6 months, while both fixed asset investment and industrial production growth have decelerated. Fears of a Chinese slowdown amidst ongoing deleveraging, alongside some positive supply adjustments, have also increased selling pressures across the commodity complex. Iron ore and coal future prices have already declined by more than 30% and 15% respectively from their recent peaks.

With policymakers balancing between deleveraging and growth, **markets are hoping that a reversal in policy tightening could be reached sooner rather than later.** These hopes were stoked after the PBoC supplied CNY459bn of MLF (medium-term lending facility) funds at unchanged rates last Friday, before providing an additional CNY170bn of liquidity via OMOs on Tuesday. Despite this, we think **the broader stance of a tighter-for-longer liquidity situation has not changed**, although policymakers will likely tweak settings at the margin to keep growth supported around the 6.5% target. Subdued foreign inflows into Chinese onshore bonds, despite significant FX liberalization measures\(^1\), also suggests that onshore yields are not yet attractive enough to reach equilibrium in liquidity with external sources.

**Liquidity: The Ins and The Outs**

**Onshore RMB liquidity is managed by the PBoC by varying the quantity of base money, with policy rates playing a secondary role,** since these are usually fixed and see only limited adjustment over time. Money supply (or “liquidity” loosely defined) is controlled by various market operations and facilities that have a range of tenors (from 1d/7d in OMO/SLO to 6M/1Y for MLF, and up to 3Y for PSL), and intended for a multitude of policy purposes.

Besides the money supply and policy rates, liquidity conditions are also jointly determined by demand from domestic banks (which require funds to make loans or fund WMPs), supply from depositors/investment funds and external inflows that are unsterilized, although these have diminished with fading RMB allure. Finally, while we note the implicit qualitative differences for the same amount of liquidity injected on different tenors, **we shall largely focus on changes in the overall quantity of excess liquidity as a gauge of PBoC’s policy stance** to maintain analytical tractability.

\(^1\) China has allowed onshore FX hedging for foreign bond investors (Feb), and is now facilitating market access for offshore investors via a Bond-Connect with Hong Kong (May)
PBoC: Restrained Pumping

Our estimate of the net liquidity injection by PBoC for May remains at a fairly small CNY100bn, even after factoring in the MLF and OMO injections last week. While it is a reversal from the average monthly drain of CNY98bn in Q1, it remains a far cry from the average monthly injection of CNY300-400bn seen in 2016. Given still robust loan demand, we believe this quantity is insufficient to drive a material easing in the tight liquidity environment. At best, we think the PBoC is engaged in a restrained pumping of liquidity, both to avoid exacerbating growth risks and to maintain a credible signal that it will rein in shadow-banking (especially Non-Bank Financial Institutions) leverage.

Swings in Chinese liquidity conditions are plausibly linked to the political cycle, which mean that a protracted period of tightening is likely if political exigencies outweigh economic concerns, although careful calibration to avoid outsized disruption should be paramount. The 2013 liquidity squeeze began soon after the Xi-Li administration came to power, raising the possibility that politicians could be hoping to pin any “credit problems” to the previous administration, rather than letting it fester into theirs. In a similar vein, today’s squeeze could be politically driven to compel a deleveraging and shakedown of the shadow banking sector, paving the way for the next Politburo Standing Committee to easily steer the economy back up again at the end of 2017.

A straight comparison of the current liquidity squeeze with 2013’s suggests that the duration is shorter, and the climb in rates is less steep this time. For instance, the 7d repo rate is still averaging below 4% in Q2 2017, whereas it has averaged above 4% for four quarters in the previous episode, starting Q2 2013. More importantly, there has not been a large reduction of “shadow banking” assets, although the pace of growth has been easing.
Backpedalling from currently tight liquidity conditions would thus be premature, and risk sending the wrong message to shadow lenders and others who had circumvented regulatory rules on leverage. **We see a strong case for further extension of tight liquidity from a risk management perspective, but with the PBoC likely tempering excessive rate jumps that could risk an uncontrolled asset-price downward spiral.** Certainly, political constraints are not at all binding until Q3 2017, just ahead of the 19th Party Congress.

**Cautious AXJ trading warranted**

We expect the likely protracted period of tight Chinese liquidity conditions to pose headwinds to Asia ex-Japan (AXJ). For one, **AXJ economies with heavy export dependence could suffer if Chinese import demand slows further on policy tightening.** With the real estate and infrastructure sectors in China being highly sensitive to rising financing costs, we believe tighter Chinese liquidity could transmit into lower import demand for hard commodities, with iron ore and coal prices likely to remain weighed. **Thus, AUD could see further downside risks despite a significant correction already.** Outside of commodities, demand for consumer and investment goods could also see a set-back amidst slower growth. We see Malaysia and Singapore as being vulnerable to a Chinese import slowdown, and expect MYR and SGD to underperform, or see reduced appreciation, under a tight liquidity scenario.

On the flip side, higher Chinese yields, to the extent that they do not topple growth expectations and undermine broader risk appetite, could allow the RMB to gain reprieve from outflow pressures, and in turn bolster AXJ currencies. Foreign bond inflows attracted by yields could also bolster the RMB (and AXJ FX sentiment), especially with much easier market access now due to the Bond Connect scheme announced yesterday.

**Our regression analysis of AXJ currencies** (period: Jan-2013 to May-2017) **confirms our bearish bias, showing the impact of higher CGB 5y yields to be negative for all AXJ currencies,** once any positive boost from a stronger yuan has been factored in. The negative impact on IDR, AUD, MYR, PHP and SGD were found to be statistically significant, with IDR registering the highest sensitivity, and SGD the lowest.

**Impact on KRW and TWD were surprisingly found to be of marginal significance,** even though both Korea and Taiwan have quite large exports to China. One interpretation is that perhaps the trade channel is less strong than the investment channel, especially given increased Chinese FDI into South-east Asia in recent years. This could explain why IDR, MYR and PHP see a more significant, negative impact that KRW and TWD.
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