China economic growth to support deep financial deleveraging reform

In recent months the Chinese financial regulators have unveiled measures aimed at reducing leverage in asset management, interbank and in the overall banking and financial system. The regulators are currently seeking public opinion before these measures are put in place in 2018. To avoid any sudden squeeze of financial system liquidity we expect these reforms to take small steps at a time so as to avoid contagion risks that could pose risks to growth.

Measures now seeking public approval would be in place in 2018

China's economic growth should continue to be strong, driven by strong consumption and fixed asset investment demand. This provides room for the central government to deal with the riskier part of the economy - reforming the banking and financial sector. But with every step it must be careful to avoid creating new risk.

Expect tighter liquidity and higher interest rates in 2018

In 2017, apart from what we have written on the kick-off of financial deleveraging through limiting the issuance of Negotiable Certificate of Deposits in the interbank, regulators have drafted regulations seeking public opinion (the final version usually is not very different from these opinion documents as the regulators usually have consulted market participants before they announce such draft measures).

There is high chance that these regulations would be in place in 2018. They include measures on commercial bank equity stake management, standardizing asset management businesses of financial institutions, commercial bank interest rate risk management of their bank book, and commercial bank liquidity risk management.

Expect financial reforms to dig deep in 2018

The heavyweight measures mean that from 2018 regulators are prepared to dig deep to reform the financial market. These measures are intertwined; measures imposed on asset management businesses will have an impact on wealth management products, interbank trading of wealth management products and the sale of these products at retail banks. These are in turn likely to affect interest rate risks and liquidity risks in the whole financial system.

When a wealth management product that packages money market funds cannot repay at maturity, it could trigger high interbank credit risks, leading to higher interest rates within a short time span. Liquidity risks may come in at the same time; and a default of wealth management products could increase interbank counter-party risk, which could easily trigger liquidity risks.

Financial deleveraging reform could also pose risks to the economy, therefore expect step-by-step changes only

We agree that measures to reform the financial sector should be in place to reduce financial contagion risks, but the imposition of these measures might create new risks. Tighter regulations alone could easily trigger what we highlight above. As such, balancing risk-reward will require regulators to implement these financial reforms slowly, so that they have sufficient time to observe market reaction and undertake corrective actions when things do not go in a desired direction.

Expect tighter liquidity and resultant higher interest rates to be broad-based

The central bank (PBoC) would anyway tighten liquidity during financial deleveraging reform to keep interbank interest rates from moving higher. As liquidity becomes tighter, there is a greater chance that banks and financial institutions rely on liquid assets so to keep their business growing. They might liquidate assets on their investment books, which could push bond yields higher, including sovereign bond yields, as well as pressure the equity market. Overall interest rates in the banking system would rise together.

2 x 10bps

Rate hike by PBoC via 7D reverse repo

This means the central bank does not need to raise rates as frequent as the Fed, even to keep spreads stable

Reform-induced higher interest rates would mean that the central bank, PBoC, would not need to follow Fed rate hikes closely, even though China would need to keep the spread stable vs US counterparts.

We expect two 10bp rate hikes on 7D reverse repo, from 2.45% in 2017 to 2.65% in 2018, in June and December.

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