

## What does slowing China M2 growth mean?

A shrinkage in shadow banking and higher interest rates



Source: iStockphoto

### We are less optimistic on M2 growth than consensus

Our forecast on M2 in June is 9.4%YoY (consensus: 9.6%, unchanged from May). We are less optimistic on M2 growth than consensus because macro-prudential measures are constraining loan growth. Banks may be growing their loan to deposit ratio but are not striving to do this through a higher deposit base. The loan-to-deposit ratio rose to 67.74% in March 2017 from 67% a year earlier.

We expect the share of non-traditional loans (i.e. entrusted loans + trust loans) will keep shrinking in June to under 10% of net monthly total social financing, a measure of the size of the broader financial sector.

### Corporates will find it more difficult to get funding via shadow banking

Concerted efforts of the government to deleverage overcapacity in corporates and banks is changing the broader financial sector in China. Companies in sectors with overcapacity that could

not get loans from banks in the past used to look for funding in shadow banking channels. However, banks are divesting some off-balance sheet items as the regulator tightens monitoring. This means those corporates will be finding it more difficult to get funding via shadow banking.

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*We believe deleveraging will push interbank rates higher*

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With limited options left, some corporates are forced to take on more expensive bank loans. However, even that is not very easy. Under macro-prudential assessment, no bank's loan growth can exceed 2.0-2.5 percentage points of the 12% targeted M2. As overcapacity companies' credit quality decreases, banks are likely to start shifting their loan portfolios away from them, and towards household mortgages.

Another way out for those corporates is to raise funds in the corporate bond market. Although still expensive, it could be preferable to defaulting on existing debts.

## Deleveraging will push interbank rates higher

The Shibor curve is inching down only slightly. 3M Shibor fell to 4.3212% on 11th July from 4.5% on 30th June. We believe, deleveraging will push interbank rates higher as the central bank has shown that it is keeping liquidity stable, rather than creating an easing liquidity environment. The PBoC's open market operations scaled down to a net injection of CNY148bn in June (not much considering it was a half-year end) from CNY199bn in May. As a result, this could put downward pressure on loan growth in coming months.

### The bottom line

As the regulators guide the size of the shadow banking sector lower, it will likely create upward pressure on interest rates across the wider financial market from the bond market to money markets.

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