

China: Soaring loan growth is a worrying signal

Credit grew at an exceptionally fast pace in June mainly due to financing for infrastructure projects. The implication is that if there were no fiscal stimulus, the economy would be deteriorating. The key question is, can the central bank keep interest rates capped given such enormous demand for infrastructure loans?



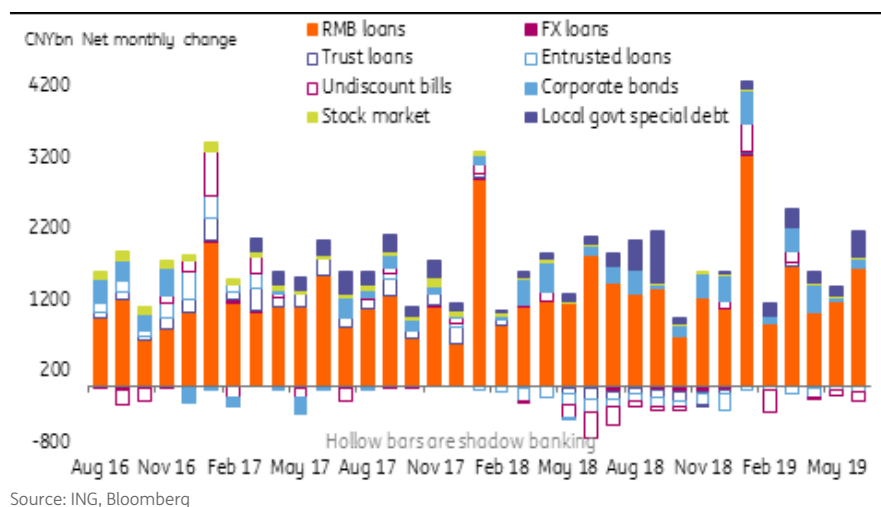
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Credit growth too strong, not a good sign

Total financing increased by CNY2.26 trillion in June, with yuan loans increasing by CNY1.66 trillion.

Credit growth was exceptionally strong and this worries us. It means the Chinese economy needs a lot of funds to keep infrastructure investment growing at a level that can maintain GDP growth above 6% at a time when manufacturing PMIs and export growth are negative.

Local government special bonds support credit growth but yuan loans still the main financing channel



There will still be big funding needs in 2H19, expect RRR cuts

There will still be big funding needs in China in 2H19, as we expect infrastructure projects to double from 2 trillion yuan to 4 trillion yuan.

These projects will raise funds from local government special bonds (net issuance of these bonds amounted to 1.19 trillion yuan), but at a later stage, when there are manufacturing activities from these projects, there will be sizeable demand for loans from manufacturers.

The central bank is expected to divert targeted liquidity to smaller manufacturers. We therefore expect two targeted RRR (required reserve ratio) cuts, one in 3Q and one in 4Q, each at 0.5 percentage points.

If the economy needs further credit, we expect these targeted measures could become broad-based, although this is not as likely as targeted RRR cuts.

PBoC doesn't like very low interest rates, but we expect two rate cuts in 2H19

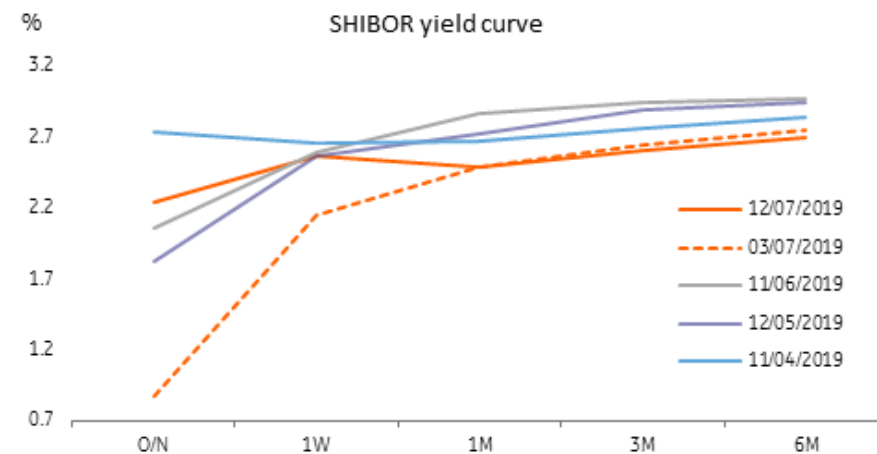
Overnight SHIBOR dropped to around 1% from the end of June to early July from a level of about 1.5%. This was driven by tight liquidity as the central bank took control of a small-sized bank. This is very likely related to a corruption case, which should be an isolated incident. The central bank has since absorbed liquidity from the system and interest rates have rebounded to around 2%.

Our views on interest rate policy are:

1. From this case, we deduce that the central bank does not like a very low interest rate environment. This is understandable because other major central banks that have very low interest rates have fallen into a liquidity trap where lowering interest rates further has failed to bring about even marginal loan growth.

2. Nevertheless, we still believe there is a high chance the PBoC will cut the 7-day policy rate twice by 5bp each in 3Q and 4Q to reinforce the impact of targeted RRR cuts. This is not to create a low interest rate environment but to avoid interest rates coming under upward pressure due to the high demand for credit to fund infrastructure projects.
3. It's even more important for the central bank to suppress high interest rates faced by micro and small firms.
4. We think if the overnight SHIBOR surpasses 2% and/or 3-month SHIBOR breaks 3%, the PBoC will cut rates.

Overnight SHIBOR has an invisible bottom of 1%



Source: ING, Bloomberg