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China's Shibor Crisis and the Fundamental Economy

Does the PBOC Really Care About Short-Term Rates?

Xi Jinping Looks at Structural Reform

The spike in China's interbank rate, called Shibor, which jumped to over 13% in the past several weeks, led to widespread concern that China's long-standing stimulus was coming to an end, which could spell a crisis in the country's banking system.

These fears are exaggerated. I just spent a week meeting with PBOC contacts in China, and participated in a workshop on Shadow Banking at the Central University of Finance and Economics in Beijing, whose faculty is close to the State Council and which coordinates its advice with two other top universities, Tsinghua and Peking University. The attitude among the top leadership – and the history of the PBOC's relationship to the Shibor – suggests that the concerns are not liquidity but the fiscal structure of local governments. The difference is important; if you think the PBOC failed to react to the Shibor hike because it was "teaching the banks a lesson," then you miss the point that the PBOC considers the Shibor to be a sideshow compared to the issues in the larger economy.

Two unpublicized events provide some support for this focus on the underlying economy. First, I was told by Beijing academics that Premier Xi Jinping held a conference two weeks ago with the country's top banking officials. Premier Xi's reportedly presented an eight-point program for interest rate liberalization to the banks, freeing them from the strict boundaries of deposit and lending rates set by the PBOC that has ruled the banking system for decades. Liberalized interest rates would have a tremendous impact on the real economy by creating a rational allocation of capital to economic actors, instead of simply shoveling buckets of cash to the reliable borrowers who are primarily inefficient state owned companies. (I am leaving out the issue of quasi-liberalized interest rates through the unofficial shadow banking system.)

October Conference

The second event – which has yet to take place – is a conference scheduled for October. According to a PBOC official who is assisting in the preparation of documents, Premier Xi is attempting to launch a significant change in the funding structure for local governments. Premier Xi is proposing a three point plan: first, he will allow local governments to introduce a real estate tax, which is now in trial in only two places, Shanghai and Chongqing; second, he will allow local governments to issue government bonds, which they can currently only do by going through the central government and is quite limited in scope; and third – and most controversial – he will attempt to transfer the power over land sales from the local governments back to Beijing. Of the 129 state companies controlled by the central government, 70% of them have invested in the property market.

Both proposals tackle two significant political forces in China – and Xi faces significant headwinds. Whether Xi will succeed or not boils down to politics. On his first proposal for liberalized interest rates, I was told that he was failed to get them passed because the state banks rebuffed him. The state banks are intent on preserving the automatic margins that come with fixed deposit and lending rates. Already, they are competing with the shadow banks and joint-stock banks for funds, and are concerned about a decline in deposits, according to a senior Bank of China official I met with in May.

The state banks have a great deal of control over allocation of loans within their jurisdictions and thus are key to the country's fiscal policy. Although targets are set in general terms by the State Council, and the PBOC has decision making power over the size of overall lending, most of the decisions on who to lend to are up to the heads of the banks in Beijing, and secondarily, the local branches, who then frequently consult local governments. Their power over nuclear plants, roads, highways, bridges and other projects is quite substantial. Projects over a certain size must be approved by headquarters in Beijing; anything below is up to the branch. Very large projects must be signed off by the State Council.

The State Banks have a close relationship with the State Council. The heads of the banks were switched around during the leadership transition. As an example of the tight bonds, the President of the Bank of China, Li Lihui, several years ago was called by a member of the State Council and asked if he wished to move to another bank. He declined, saying he had spent seven years at BOC and had formed relationships there that would be time consuming to replicate at another institution. Thus, he kept his current job. Just last week the State Council named a veteran bureaucrat named Ding Xuedong to the high profile job of chairman of China Investment Corp., the $480 billion state investment fund. Ding has little exposure to international investing, and in fact he is most experienced in the agricultural sector. But he is considered a "safe" choice because he has a doctorate from within the bureaucracy – the Ministry of Finance's Research Institute – and has close ties to economic expert Wang Yang of the State Council. CIC lost money on several overseas investments, which was an embarrassment that the leadership is eager to avoid.

That is why the banks' opposition to interest rate form – despite the tight knit relationship with the leadership – shows how deposit and lending rates are core to their existence.

The Next Battle – Beijing Against the Provinces

The second Xi proposal on local government financing goes to the heart of the concerns at the top about local fiscal debt – and faces significantly more political pressure than the banking reforms. Provincial officials earn an average half of their fiscal revenue from land sales. Taking this away would cause a major shift in local fiscal financing, and in the overall relationship between Beijing and the Provinces. It is as ambitious as Zhu Rongji's centralization bid in 1994, when, faced with dwindling central government revenue, he wrested control over tax revenue from the local governments, in exchange for greater responsibility by Beijing for payment of local social services. Measured by contribution to social welfare, China is the most decentralized country in the world, according to the World Bank

Although China's budget law requires local governments to shun indebtedness of any kind, they have recently routinely circumvented this dictum through the off-balance sheet local government financing vehicles. The LGFVs raise external debt capital from banks and local lenders but are widely perceived as backed by local governments. Much of the current local government debt stems from the collapse in the 1999 of an earlier funding mechanism through the Rural Credit Foundations, whose liabilities were absorbed by the local governments.

Politically, local governments free-spending habits (known as soft budget constraints) have been supported by the National Development and Reform Commission in tandem with certain officials in the State Council. Ending this cozy relationship will not be easy for Premier Xi.

Interestingly, China Daily July 1 published an editorial calling for allowing defaults of failed LGFVs. "The apparent security (of LGFVs) has hindered the healthy development of the debt market," said Liu Dongmin, a researcher with the Institute of World Economics and Politics at the Chinese Academy of Social Sciences. He said LGFVs in Yunnan and Shandong Provinces in 2011 couldn't make debt payments but were not allowed to fail, backed by the local governments. They should have defaulted, in his view.

Beijing no doubt wants to avoid a repeat of the recap of local governments over a decade ago. According to University of Toronto's Lynette Ong, the Central Bank handed out two major forms of financial subsidies—165.6 billion *yuan* in debt-for-bills swaps (zhuanxiang *piaoju)* and 830 million *yuan* in earmarked Central Bank loans (zhuanxiang *daikuan)—to* assist the Rural Credit Cooperativess with negative net worth in disposing of their bad assets and erasing their historical losses.

It's the Economy, Stupid.

The second issue that has led investors and analysts astray is the excessive focus on Shibor. In the mind of the central bank, Shibor is a bit player in China's financial theater. "We don't the see the Shibor as terribly important," a PBOC official in Shanghai told me in June. The alarming spike in China's interbank interest rates caused a frisson of concern among investors who began thinking this spelled the end of China's credit boom. The 7Day Interbank Repo rose to above 11% briefly before falling back down while the Shibor climbed above a record 13%.

China Liquidity	6M Loan Yield on Discount Bills	3M Shibor	7 Day Interbank Repo
6/26	8.08%	6.08%	5.80%
6/25	8.11%	5.96%	7.50%
6/24	7.61%	5.74%	7.57%
6/21	9.61%	5.79%	5.50%
6/20	7.61%	5.80%	11.20%

This massive jump in the interbank market was taken as a clear sign that the PBOC was withdrawing liquidity from the system because it is widely assumed that the Shibor is a fair representation of liquidity conditions in China and reflects the attitude of the PBOC toward monetary policy in general. Watch the Shibor and you can take the pulse of the Chinese financial system --- and the PBOC is the doctor with the stethoscope. As one financial pundit in New York wrote on his blog, "This is roughly the equivalent of the Fed not being able to control the fed funds rate."

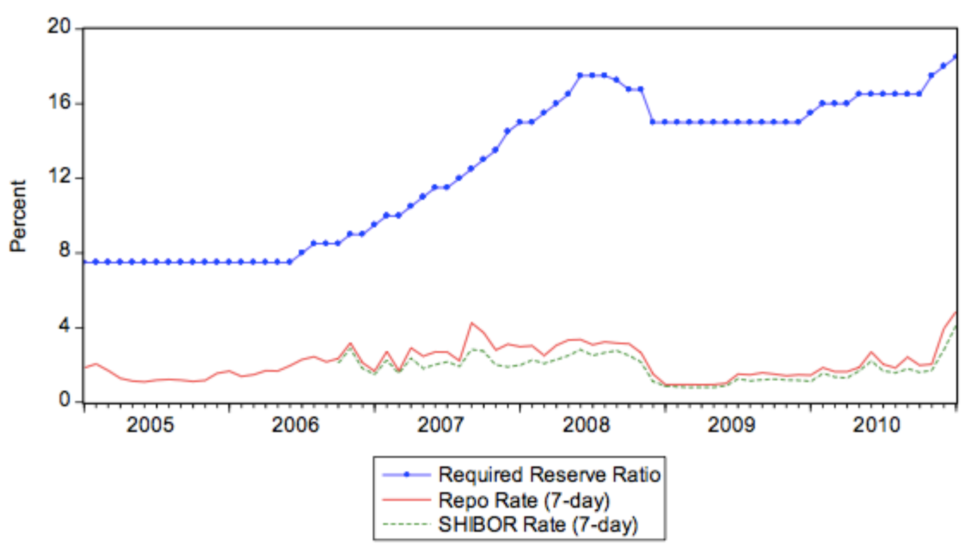
In fact, the Shibor is not widely respected within the PBOC as a representation of liquidity in the banking system. Within the bank, there is a great deal of reluctance to tighten or loosen when there is short-term volatility in the interbank markets.

This is supported by the historical evidence. The Shibor is not quite as useful a tool for monitoring the Chinese economy as people think. A number of studies by institutions including the International Monetary Fund and the Hong Kong Institute for Monetary Research (HKIMR) have failed to find much of a connection between the real economy and the Shibor. "Interbank money market lending rates, such as Repo and Shibor, are insufficient and potentially misleading indicators of the central bank's monetary policy intentions," notes a recent HKIMR working paper.

Why? Primarily because the PBOC focuses its efforts on administrative measures – mainly ways the bank can affect retail deposit and lending rates by administrative fiat. Unlike the western economies such as the U.S., where the Fed intervenes by buying or selling paper to the banks through open market operations to reach a targeted interest rate, the PBOC prefers to control lending directly through its oversight of the banking system, mainly through the four state banks. And many of these actions don't affect the interbank rates.

Take a look at the movement in the reserve requirement ratio (RRR). Historically it has had little impact on interbank rates.

Figure 2. RRR and Interbank Rates



Source: CEIC and Hongyi Chen, Qianying Chen and Stefan Gerlach of the Hong Kong Monetary Institute.

In fact, changes to many policy variables, including open market operations and the RRR, do not have a significant impact on the interbank interest rates. The biggest impetus to interbank rate changes are purely time sensitive – Chinese New Year and the end of the month have the largest impact on interest rates. (Nathan Porter and TengTeng Xu, IMF).

That leaves the interbank market, reflected in the Shibor rate, a bit of an orphan, prey to the fears and whims of the banks, with little or no impact on deposit or lending rates. Instead of the wholesale money market driving the monetary train, as in Europe and the U.S., the retail market is the most significant determinant of liquidity and interest rates. And the PBOC controls the retail market through the deposit and lending rate directly. The PBOC also quietly tells the banks how much they should be lending. If they don't listen, they could lose their jobs. It's a bit like the tail wagging the dog – consumer banking driving wholesale banking. According to Porter and Xu:

"The initial direct impact of a 100 basis points rise in the lending rate is to increase the interbank rate by 75 basis points, but after three days this direct impact is only 3 basis points. An increase in the deposit rate has the opposite effect, reducing the interbank rate, reflecting a likely supply response on the part of depositors, given the low regulated interest rate as suggested by our stylized model. The initial direct impact of a 100 basis points rise in the deposit rate is a 43 basis points fall in the interbank rate, although the interbank rate is less than 3 basis points lower (due to the direct impact) after three days but this is still significant. "

They conclude that "short-term interbank lending rates are not able to act as an independent benchmark for asset pricing, or an independent indicator of macroeconomic or financial conditions."

The Shibor, though, may have other uses in the form of less quantitative signaling when the PBOC fails to intervene during a period of volatility in the Shibor. There have been hints – affirmed by my contacts – that the PBOC would like to teach the banks, particularly the small banks, a lesson about keeping lending down to a dull roar. The failure to intervene was one such signal. The PBOC is concerned that the expansion of the money supply from the sale of "Wealth Management Products". Hence the Shibor signalling. But a hint about policy is not the same as a hard number in an index whose impact spills through the economy at large. The Shibor is not like the Federal Funds Rate in the U.S. and should not be seen as such. Interestingly, there is an unproven rumor in Beijing that the PBOC did encourage the China Investment Corp. to inject funds into the interbank market, acting as a surrogate for the PBOC. This fits with the framework that the bank doesn't want to seem to be reacting too quickly to the Shibor but may have gotten a tad worried.

Was there a lesson being taught to over-spending banks when the PBOC failed to act at the first signs of liquidity constraints? Yes. There is a general feeling within the bank that the loans have gotten out of hand. However, although the PBOC is the traditional backstop to preventing inflation, PBOC Governor Zhou Xiaochuan is known to favor liberalizing interest rates – and the he knows that the shadow banking market is the only way to achieve that. But the PBOC is not worried about short-term liquidity. As a PBOC official noted, "There may be 5% to 10% of failures in the wealth management products, but most of them are pretty healthy."

So what are better things to watch for to get clued into China's monetary system?

First are the administrative targets set by the PBOC. These include the Reserve Requirement Ratio (how much cash the banks need to keep on hand), and the actual targets for lending. Generally, there is a lot of guessing in the press and among analysts on these two policy measures, which are heavily tracked. However, much of this activity goes on behind closed doors. For example, the local branches of the state banks have broad lending quotas, but the larger, most capital-intensive projects, must be approved by their headquarters in Beijing. Those guidelines are loosely – and from what local branch managers tell me, very loosely -- set by the PBOC and the State Council.

Also, corporate bond yields tend to be correlated with economic activity. According to Nuno Cassola and Nathan Porter at the IMF, implied long-term corporate bond spreads over Treasuries are correlated with Chinese inflation up to 7 months in advance and with GDP growth up to two months in advance – a useful bellwether for analyzing the economy.

There's no doubt that there is a liquidity crisis for many lenders, particularly smaller trusts and some of the joint-stock banks. And while there is little data, the State Banks have done their share of off-balance sheet lending. But the State Council and the PBOC are focusing their policy efforts on deeper structural changes in the economy.