Chinese Banks Are Dumping Dollars in Swap Markets, Traders Say

- Onshore yuan swap costs surge to highest in almost four years
- Some lenders lack investment avenue for their dollars

By Bloomberg News

(Bloomberg) --

Surging demand from China's banks to offload excessive dollar holdings is adding to signs of liquidity stress in swap markets ahead of monthly operations from the People's Bank of China on Wednesday.

One-year dollar-yuan onshore swap points -- a gauge of funding costs for the Chinese currency via the foreign exchange market -- climbed to 1,843 pips Tuesday, the highest in almost four years. The move indicates that banks are rushing to swap dollars for yuan, pushing up the cost of doing so.

Cash from around the world continues to flow into China, where onshore foreign currency deposits of about $1 trillion are just off the record reached in June. Some banks have too much dollar liquidity but no good channels to invest in, so they have to swap them for yuan, according to traders who asked not to be named as they're not authorized to speak publicly.

Onshore banks are likely using the swaps market to avoid being left with large currency exposures, said Ju Wang, senior FX strategist at HSBC Holdings Plc. The implied yield of the one-year swap rate rose to 2.81%, the highest since August 2015, according to data compiled by Bloomberg.

Multiplying Crackdowns Haven't Stopped Cash Pouring Into China

Higher swap costs could also make it more expensive for offshore investors to buy and hold yuan assets, and eat into returns. The one-year onshore swap implied yield -- taken as a gauge of costs -- is now higher than the yieldavailable on a top-rated one-year negotiable certificate of deposit sold by Chinese banks.

Foreigners cut their holdings of NCDs -- essentially short-term debentures -- for a second month in August.

Tight Liquidity

Tighter onshore interbank liquidity could be another reason for the rise in swap rates, said Stephen Chiu, Bloomberg Intelligence Asia FX & rates strategist. That should ease a tad after the PBOC's medium-term lending facility injection on Wednesday, he added.

China's onshore overnight repo rate -- a gauge of funding costs in the interbank money market -- touched 2.31% Tuesday, the highest in about three months. The country's benchmark 10-year government bond yield climbed above 2.9% for the first time since late July.

The PBOC is expected to conduct its monthly MLF operation on Wednesday, with 600 billion yuan due. Last week a central bank official said that interbank liquidity should remain balanced in the coming months, damping speculation that there'll be another cut in the required reserve ratio soon.

Money market traders are more cautious this month as cash demand could rise due to quarter-end regulatory checks and before China's Golden Week holiday in early October. If the maturing MLF is not mostly rolled over or covered by another liquidity injection, market sentiment is likely to be further impacted, said Frances Cheung, rates strategist at Oversea-Chinese Banking Corp.

Evergrande Woes

Concern about the property sector amid the potential restructuring of China Evergrande Group -- the world's most indebted developer -- could also be impacting swap rates.

Market participants might be preparing for "the liquidity squeeze in crisis mode," Mizuho Bank Ltd. chief Asian FX strategist Ken Cheung wrote in a note.

"Rising property sector concerns and specific credit concerns around Evergrande are raising pressure on banks' liquidity management," Eddie Cheung, senior EM strategist at Credit Agricole, wrote in a note. He expects onshore yuan liquidity conditions to remain tight in the near term.

(Updates prices, adds context in the 10th paragraph and Credit Agricole note in the last paragraph)

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--With assistance from Qizi Sun and Chester Yung.

To contact Bloomberg News staff for this story:
Charlie Zhu in Shanghai at qzhu46@bloomberg.net;
Wenjin Lv in Shanghai at wlv8@bloomberg.net;
Ran Li in Beijing at rli279@bloomberg.net

To contact the editors responsible for this story:
Charlie Zhu at qzhu46@bloomberg.net
Cormac Mullen, Liau Y-Sing