China Engineers Biggest Cash Squeeze Since 2015 to Avoid Bubbles
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By Bloomberg News

(Bloomberg) -- Beijing is so fearful of speculative manias that authorities are creating the biggest liquidity crunch in more than five years, roiling Chinese stocks and bonds and freezing a key funding market.

The cost of overnight interbank borrowing surged 29 basis points to 3.3433% on Friday, the highest since March 2015 and above the yield of China's 10-year government debt. Earlier this month the overnight rate was just 0.6%. The real rate was even higher for some would-be borrowers, with brokers offering funds at 10% or higher, according to traders.

"The market is under huge liquidity stress," said Xing Zhaopeng, an economist at Australia & New Zealand Banking Group.

The cause of the squeeze is the central bank's aggressive draining of funds from the financial system this month via different tools. That's left banks reluctant to lend in the short-term, especially in the weeks before the crucial Lunar New Year holidays, when liquidity is typically tight. While state media have been publishing prominent commentary effectively telling people not to worry about the availability of funds, that's been little solace to leveraged investors.

On Friday afternoon, speculation spread that the People's Bank of China will hike the cost of a short-term loan. Volatility swept the country's sovereign bond market, with the 10-year yield spiking and trading briefly suspended for a one-year note. The PBOC later said the speculation was untrue and reported it to the police.

The stock market is jumpy too. The CSI 300 Index slumped almost 5% since Monday, when it closed at a 13-year high, while margin debt in the market has fallen from its highest level since a bubble burst in 2015.

Bubbles have long been a concern to the Communist Party. Capital borders mean the country's 1.4 billion people have few investment options. Abundant liquidity in the past has fueled speculative frenzies in everything from housing to equities and commodities, something that the government is keen to avoid. Officials don't have to look hard to see the effect of easy money in the rest of the world on asset prices, and the risk of a sharp reversal.

In China, however, the bursting of a bubble has the

potential to create social instability, which could threaten the
Communist Party's rule.
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Signs of overheated markets were popping up all over China after authorities flooded the financial system with funds at the end of 2020. While the goal was to stabilize sentiment after a spate of high-profile credit defaults, the result was a stream of cheap money with nowhere to go. Excess liquidity made its way into a popular bond-market carry trade, sent a gauge of domestic stocks to near a record and flowed at an unprecedented pace into Hong Kong's shares.

For a central bank known to leave traders guessing on policy, the PBOC's move to dispel market "rumors" on Friday shows how extreme the liquidity concerns have become. Chinese banks will need about 1 trillion yuan ($155 billion) to plug a funding gap before the weeklong holiday that starts in mid-February, according to the median estimate of six analysts surveyed by Bloomberg.

PBOC adviser Ma Jun told local media earlier this week that risks of asset bubbles -- such as in the stock or property market -- will remain if the central bank doesn't shift its focus toward job growth and inflation management instead of economic output. Friday's squeeze -- probably exacerbated by month-end factors -- came as the PBOC added a net 98 billion yuan of short-term cash to the banking system.

The interbank repo market -- short for repurchase agreements -- is an important source of funding for Chinese financial institutions, which are in turn the biggest buyers of the country's sovereign debt. There are about 15 trillion yuan worth of pledged repos outstanding, according to official data as of December.

"Markets are very sensitive to funding costs," said Dariusz Kowalczyk, senior emerging-markets strategist at Credit Agricole CIB. "Typically it's the short-end that reacts the most, but even the 10-year yield is quite volatile today. People are afraid that the PBOC could more permanently tighten liquidity conditions."

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