CHINA Insights

OCBC Bank

The end of easing cycle

Tuesday, January 24, 2017

Highlights:

- **PBoC raised interest rate for both 6 month medium term lending facility (MLF) and 1 year MLF by 10bps. This is the first time for PBoC to adjust one of its policy interest rates higher since July 2011.**
- **Although PBoC has left its benchmark 1-year lending and deposit rate unchanged since October 2015, the adjustment of its MLF rate clearly confirmed that China's easing monetary policy cycle has officially ended.**
- **The hike was mainly attributable to four factors including concerns about rapid credit expansion in January, positive growth outlook, commitment to contain financial risk and rising inflationary pressure.**
- **However, it might be still too early to jump to the conclusion that China has started tightening cycle. The next important thing to monitor is the interest rate for open market operation. Our forecast for 2017 benchmark lending and deposit rate remains unchanged for now.**
- **The tight bias monetary policy may not bode well for risk sentiment. As such, we may see rising volatility in both bond and equity markets. However, the tight liquidity may be good news for RMB.**

The onshore media Caixin first reported after stocks trading hours that PBoC raised the funding cost for 1-year medium term lending facility (MLF) by 10bps to 3.1%. As a result, China's bond futures tumbled by more than 0.8% at one point. The news was later confirmed by PBoC that the 10bps rate hike was broad-based for both 6-month MLF and 1-year MLF. This is the first time for PBoC to adjust one of its policy interest rates higher since July 2011.

Although PBoC has left its benchmark 1-year lending and deposit rate unchanged since October 2015, the adjustment of its MLF rate clearly confirmed that China's easing monetary policy cycle has officially ended. The "tight bias" monetary policy is no longer a slogan but an attitude as well.

Corporate FX & Structured Products
Tel: 6349-1888 / 1881

Fixed Income & Structured Products
Tel: 6349-1810

Investments & Structured Product
Tel: 6349-1886

Interest Rate Derivatives
Tel: 6349-1899

Treasury Research & Strategy
Tel: 6530-4887

Tommy Xie Dongming
+(65) 6530 7256
xied@ocbc.com

Chart 1: Outstanding of MLF

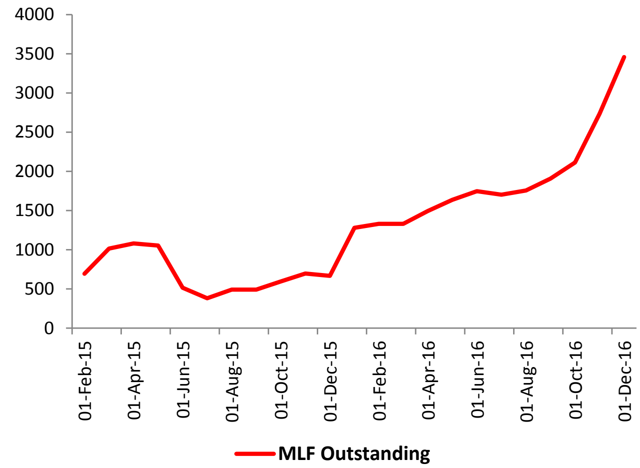
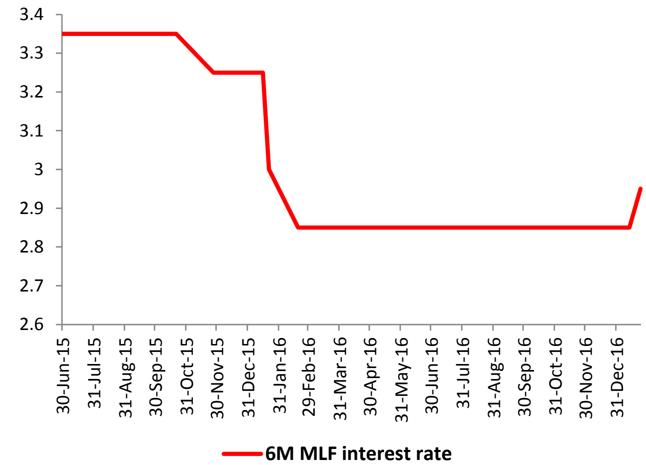


Chart 2: 6M MLF interest rate



Source: Bloomberg, OCBC

For Chinese bond investors, it could be a roller coaster moment for the past few days. Investors initially cheered last Friday after the market talk that China cut reserve requirement ratio for five big banks for 28 days. However, it was later confirmed that PBoC launched a new liquidity tool "Temporary Liquidity Facility (TLF)" to meet festival liquidity demand. The TLF, which does not require collateral, is designed to skirt around the limitation of collateral faced by MLF. The key difference between RRR cut and this new TLF is that participating banks, which access to TLF, need to pay interest rate similar to open market operation, much higher than that for RRR cut. The launch of costly TLF last Friday is a warning shot that PBoC does not want market to misread liquidity injection as easing gesture.

Since the start of 2017, market has already speculated the possibility of rate hike for MLF. However, the timing, two days ahead of Chinese New Year still caught us by surprise. We think the hike was mainly attributable to four factors. ***First,*** it may serve a warning shot to banks which manage their liquidity poorly. It was rumoured that credit expansion could hit a record high in January despite window guidance from the central bank. ***Second,*** the recovery of Chinese economy gave PBoC confidence to increase interest rate marginally. ***Third,*** the hike of MLF interest rate also signals China's commitment to contain financial risk, which is the key task for 2017. Since 4Q 2016, China has tightened in both property and bond markets to squeeze the asset bubble. The latest rate hike will help China consolidate its gain in both battles. ***Fourth,*** the rate hike decision is probably also the result of rising inflationary pressure. Both CPI and PPI are expected to rise further in January due to Chinese New Year effect. In particular, PPI may test above 7% due to base effect. As a result of possible pass through effect from PPI to CPI, inflationary pressure may be one of the key focuses for PBoC in 2017.

Chart 3: Watch out for reverse repo rate

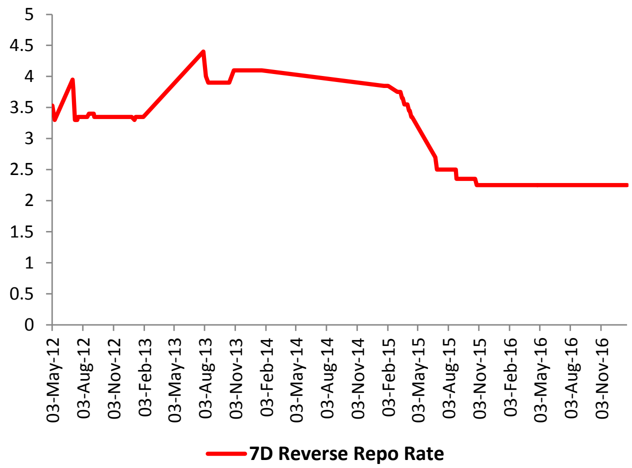
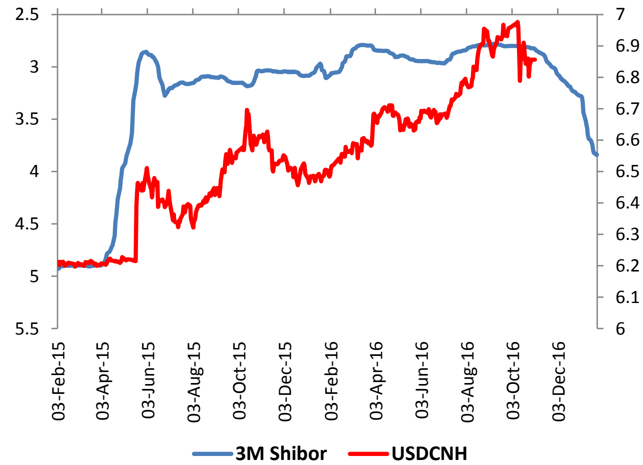


Chart 4: Tight liquidity is good for RMB



Source: Bloomberg, OCBC

What's next?

We think today's MLF rate hike confirmed the end of easing monetary policy cycle, however, it might be still too early to jump to the conclusion that China has started tightening cycle. The next important thing to monitor is the interest rate for open market operation. Should China raise interest rate for 7-day reverse repo, the expectation on benchmark lending rate hike may heighten given the tight correlation between reverse repo rate and benchmark lending rate. Whether China will eventually hike benchmark lending and deposit rate will depend on the inflation outlook. We still maintain our forecast for benchmark interest rate in 2017 unchanged now.

Implications

The tight bias monetary policy may not bode well for risk sentiment, in particular after this earlier than expected MLF rate hike. As such, we may see rising volatility in both bond and equity markets. However, the tight liquidity may be good news for RMB, which will continue to help manage expectation on RMB depreciation.

Co.Reg.no.:193200032W