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The PBoC has begun injecting more liquidity into the interbank market after the rise in bond yields.

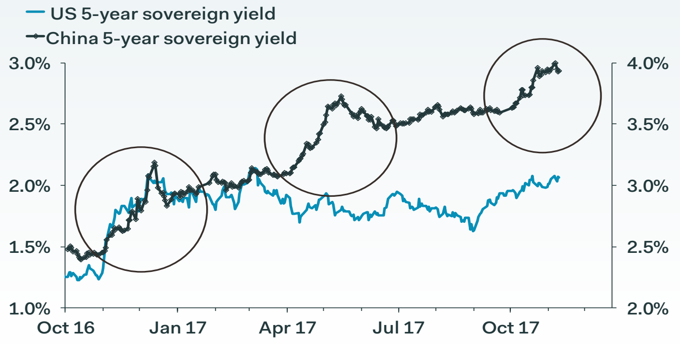
China cannot escape the impossible trinity as the Fed raises rates; FX reserves to start falling again.

Untangling China's bank ownership would be hugely beneficial for GDP growth, but is a difficult task.

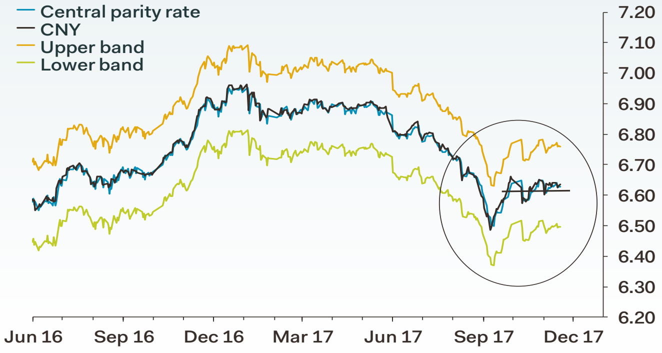
PBoC Lets up After Tightening Ahead of Fed Hikes

The PBoC has let up on its open-market operations after allowing bond yields to move higher again in October. *Underneath all the monetary policy levers, the PBoC appears to be targeting the interest rate differential with the U.S..* The current aim seems to be to keep the RMB stable, requiring an upshift in yields in October, for the second time this year. Deleveraging was the talk of the town among the financial policymakers at the Party Congress last month, and liquidity injections had been relatively restrained until that point in the year. Meanwhile, PBoC governor Zhou Xiaochuan was talking about GDP growth comfortably above target for 2017, implying the authorities have plenty of room to rev up their deleveraging drive. The RMB, in turn, began to move sideways before the Congress.

PBOC SATISFIED WITH THE INTEREST DIFFERENTIAL AGAIN



PBOC HOLDS THE RMB STEADY FOR NOW

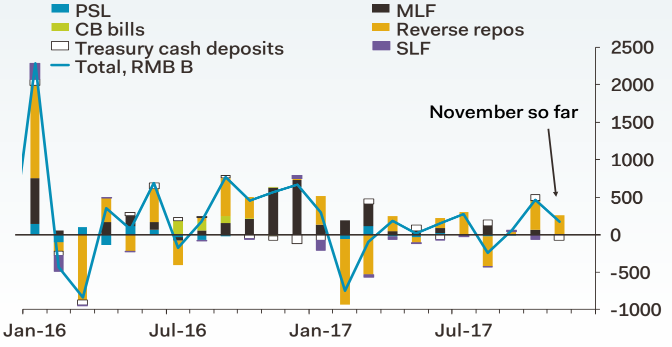


This tightening could have been an attempt to preempt the December Fed hike. *Moving first, rather than reacting to higher external rates next month, suggests that the PBoC still is unwilling to allow the RMB to depreciate significantly.* But the method of achieving RMB stability looks to have changed in recent weeks.

Far from the RMB *appreciation* that followed the Q2 rise in domestic yields, the RMB now appears to be sustaining pressure to *depreciate*. After domestic rates rose in Q2 the RMB rose because the interest differential had noticeably increased in China's favour. But the October rise in yields didn't shift the differential up by nearly as much. Moreover, the PBoC has stepped in against the rise in yields in recent weeks, increasing its liquidity injections.

Injections since October suggest the FX reserves

PBOC RAMPS UP NET LIQUIDITY INJECTIONS



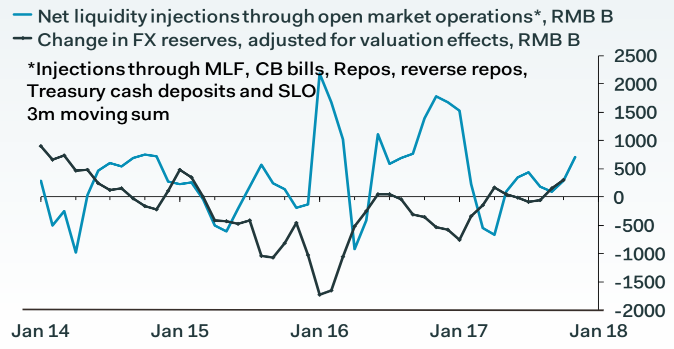
should soon turn down again. The blue line and the black line in our final chart mirror each other, roughly, indicating that in some cases, the PBoC deliberately counterbalances the two arms of its policy: FX intervention and RMB interbank liquidity intervention. The PBoC sterilises FX sales by mopping up RMB liquidity and anti-sterilises FX purchases by increasing its net injections of RMB. These two lines are on the two sides of the PBoC balance sheet. The more liquidity the PBoC injects, the more FX it eventually has to spend to buy that liquidity back as capital leaves China.

The problem goes even further. The PBoC is attempting to walk the line between preventing interest rates from rising too rapidly and preventing capital from fleeing too quickly. Zhou has taken to claiming that the impossible trinity between domestic rates, the exchange rate and capital flows has become less binding than in the past.

Zhou's assertion is about to be put to the test. Markets are hopelessly complacent about Fed policy normalisation, even without the late-cycle tax cuts, currently pending in Congress. At the same time, our chief eurozone economist, Claus Vistesen, believes that eurozone interest rate expectations will creep higher next year. This would release some of the downward pressure on long-end yields in the U.S.

Ultimately, targeting the interest differential when Fed policy normalisation is in full swing will become self-defeating for the PBoC. China is now much more sensitive to interest rate increases than the U.S., so the higher U.S. rates rise, the further they have to rise in China order to offset the increase in risk. *In the end, the PBoC will have to concede a lower RMB.* The risk in the first half is that U.S. wage growth picks up, as we expect, and markets finally get on board with Fed normalisation. *If the PBoC chooses this moment to concede that the RMB is overvalued, that would add a nasty sting in the tail to financial market volatility next year.* Looking longer term, an overvalued RMB still is thinkable, whilst external demand remains strong, which it should in 2018. But when the U.S. cycle ends, China's uncompetitive currency will become an even greater burden.

INJECTIONS ARE INDICATIVE OF RENEWED DECLINE IN FX RESERVES



China moves to unravel bank shareholdings

The China Banking Regulatory Commission has made proposals in recent days to untangle bank ownership structures. We have written previously about banks owning each other's shares and tier-two capital instruments, a problem which has worsened this year. Draft regulations aimed at unravelling this mess would be hugely beneficial in the long-run.

To build a healthy economy, China will need to build a healthy banking system. In turn, the health of the banking system is not sustainable unless prospects about future GDP growth are positive enough to maintain a normal upward-sloping yield curve. The implied profits would entail robust dividend growth. ***But if banks are major holders of each others' equity, much of these dividends just slosh round the income statements of the banking system, never getting back into the real economy to support income growth and private consumption.*** Essentially, an upward-sloping yield curve would gradually suck resources out of the real economy into the financial sector until prospects about the future were so dim the curve becomes depressed.

Achieving this disentanglement will be no easy task, however, especially as banks' share prices have risen solidly this year. *Admitting that much of the supposed new capital from IPOs and tier-two capital issuance has just been recycled from other parts of the banking sector would put a bit of a dampener on the party.*

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THIS WEEK IN BRIEF

Data and events to be covered in the Asian Data Wrap.

Monday, November 20

- **Japan: Trade Balance (10) 08:50 JST**

The unadjusted trade balance probably declined to **¥397.4B** in October, from ¥667.7B in September. But on our adjustment, the balance likely was stable, with exports ticking up again after falling 0.2% m/m in September. Meanwhile, imports should also grow in line with exports, after the weakness in Q3. **Consensus: ¥330.0B.**

- **Japan: Exports (10) 08:50 JST**

Exports probably grew **12.9%** y/y in October, slowing from the 14.1% rate in September. Exports rebounded strongly in Q3 but faltered in September, as exports to the U.S. fell m/m after a sturdy increase in the previous two months. The storms that hit the U.S. in September could be damaging Japan's exports but trade should rebound in coming months. Exports to China will begin to slow again as the pace of price increases likely has peaked, while the economy is weakening and production curbs, aimed at avoiding a winter pollution spike, should further dent demand in Q4 and Q1. Europe likely will continue to be supportive, however, thanks to the favourable yen-euro exchange rate and still-strong European demand. **Consensus: 15.7%.**

- **Japan: Imports (10) 08:50 JST**

Imports probably grew **16.4%** y/y in October, up from 12.1% in September as domestic demand gets back on a stable footing after the downward correction in Q3. Both private consumption and capex should rebound as regular wages continue to grow, while exports bounced back in Q3, lending confidence to capex and related imports as corporate borrowing remains robust. Price rises likely slowed at the margin. **Consensus: 20.2%.**

Tuesday, November 21

- **Korea: 20-day Exports (11) 09:00 KST**

20-day exports should rebound to **14.0%** y/y in November from 6.9% in October, which probably understated growth. But exports have weakened at the margin. **Consensus: N/A.**

- **Japan: All-industry activity index (9) 13:30 JST**

The index should fall **0.2%** m/m in October, after a 0.1% rise in August, after weak GDP growth in the quarter. The index also over-predicted in Q2, so could over-correct in Q3. Activity should rebound in Q4, as domestic demand gets back on track, though the outlook for exports is shaky with slowing Chinese demand and the storm damage in the U.S. **Consensus: -0.4%.**

Wednesday, November 22

- **No major data released.**

Thursday, November 23

- **No major data released.**

Friday, November 24

- **Korea: Consumer Confidence (11) 06:00 KST**

Confidence should fall to **105.2** from 109.2 as the index has been seasonally elevated and the post-election burst wears off. **Consensus: N/A.**

- **Japan: Nikkei PMI Manufacturing (11) 09:30 JST**

The PMI likely was unchanged at **52.2** in November. Domestic demand should rebound after Q3 weakness but trade could be soft in Q4 thanks to the storms, in the U.S. and weakening demand in China. **Consensus: N/A.**

CHINA ECONOMIC FORECASTS

	q/q			y/y	
GDP	Official	PM est.		Official	PM est.
Q3 2017	*1.7%*	*1.8%*	*2015*	*6.8%*	*5.5%*
Q4 2017	1.6%	1.2%	*2016*	*6.8%*	*6.7%*
Q1 2018	1.6%	1.2%	*2017*	*6.8%*	6.4%
Q2 2018	1.6%	1.2%	*2018*	6.4%	5.1%
Q3 2018	1.5%	1.3%			

	CPI, y/y		**PPI, y/y**
	Headline	Non-food	Headline
Dec-17	1.8%	2.4%	5.7%
Mar-18	2.2%	2.4%	4.8%
Jun-18	2.2%	2.5%	4.3%
Sep-18	2.1%	2.5%	3.7%

Monetary policy: Higher interest rate corridor in 2018H1.

JAPAN ECONOMIC FORECASTS

GDP	q/q SAAR	y/y	**CPI**	Headline	Core
Q4 2018	0.7%	1.4%	*Dec-17*	0.8%	0.2%
Q1 2018	1.0%	1.5%	*Mar-18*	0.9%	0.5%
Q2 2018	0.9%	1.0%	*Jun-18*	1.1%	0.9%
Q3 2018	0.9%	0.9%	*Sep-18*	1.2%	1.2%

Monetary policy: Policy balance rate to 0.0% early next year; 10-year target to 0.2% early next year.

KOREA ECONOMIC FORECASTS

GDP	q/q	y/y	**CPI**	Headline	Core
Q4 2017	0.6%	3.7%	*Dec-17*	1.8%	1.4%
Q1 2018	0.7%	3.3%	*Mar-18*	1.4%	1.4%
Q2 2018	0.3%	3.0%	*Jun-17*	1.2%	1.4%
Q3 2018	0.2%	1.8%	*Dec-18*	1.0%	1.3%

Monetary policy: Rates on hold.

ASIA FINANCIAL FORECASTS

		Dec	**Mar**	**Jun**	**Sep**
10-year, %	China	3.80	4.00	4.10	4.10
	Japan	0.00	0.00	0.20	0.40
	Korea	2.40	2.50	2.70	2.80
Curve 30-2, bp	China	50	55	60	70
	Japan	110	110	110	130
	Korea	85	100	110	130
FX	CNY	6.8	7.2	7.2	7.2
	JPY	116	118	118	116
	KRW	1150	1160	1160	1160