China
Credit

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Cash crunch reveals stress points

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Zhi Ming Zhang
Head of China Research
The Hongkong and Shanghai Banking Corporation Limited
+852 2822 4523 zhimingzhang@hsbc.com.hk

Helen Huang
China Credit Research Analyst
The Hongkong and Shanghai Banking Corporation Limited
+852 2996 6585 helendhuang@hsbc.com.hk

View HSBC Global Research at: http://www.research.hsbc.com

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- **Beijing is stepping up efforts to rein in China's credit growth**
- **Last week's cash crunch should help start the process of deleveraging**
- **But in the short term this will put further stress on China's credit system**

China's central bank, the People's Bank of China (PBoC), surprised the markets last week by tightening liquidity in the interbank markets, causing money market interest rates to hit record levels. The cash crunch comes after a prolonged surge in credit has failed to boost growth in China. Total social financing (TSF), the government's broadest measure of credit, is now 60% higher y-t-d than a year ago, when it was already considered to be high.

Undeterred by a slowing economy, China's new leaders have made it clear they are reluctant to use fresh fiscal or monetary stimulus to revive growth. At the same time Beijing has acknowledged that planned reforms will take time to have an impact on the economy and this likely means lower GDP growth in 2013 and 2014 (we now forecast 7.4%, see *China: Faster reform, slower growth*, 19 June).

To us, the liquidity squeeze shows that problems associated with the rapid expansion in credit are now high on the policy agenda. On 18 June the State Council, China's cabinet, said the nation "must more firmly guard against financial risks". But reining in credit growth at a time when the return on those investments has been falling could put further strain on the credit system. And although the US economy is improving, proposed tapering of quantitative easing by the US Federal Reserve and a rapid rise in US Treasury interest rates and the USD could put more pressure on onshore liquidity. This report looks at what's behind the cash crunch and three areas where there is evidence of pressure building up in the credit system:

- Cross-border money flows and the subsequent threat of default risk.
- Delayed payments for wealth management products and the increasing funding dependence on these products by small city commercial banks.
- Rising mutual debt guarantees among listed companies.

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Pressure points

- China is tightening bank liquidity, which is putting pressure on the credit system
- We think this shows that Beijing is addressing the financial risks in its domestic economy
- We look at three new pressure points – default risk from cross-border money flows, wealth management products and corporate debt guarantees

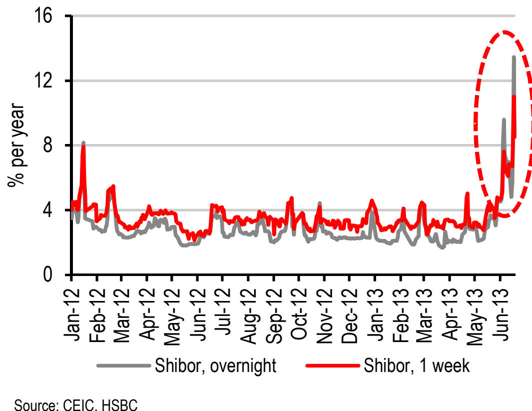
Tighter and tighter

China is tightening the credit tap. The PBoC took the markets by surprise last week by introducing much tighter liquidity in the interbank markets, with the aim of forcing domestic financial institutions to deleverage. Money market interest rates began to pick up at the end of May but the PBoC didn't inject liquidity as usual, leading to several peaks in the onshore credit market since mid-June, including:

- The one-day repurchase rate hit an all-time high of 30% in Shanghai during trading hours on 20 June (Figure 1).
- The seven-day repo rate also reached a record high of 25% (Figure 1).
- Banks paid 6.5% for RMB40bn of six-month deposits from the Finance Ministry, the highest rate since March 2012 and up from 4.8% at the previous auction on 23 May.
- Only RMB9.53bn of the RMB15bn 6-month Ministry of Finance issuance was taken up on 14 June, despite offering yields of 3.76%, much higher than the expected 3.14%.
- The Agricultural Development Bank of China, one of the three policy banks, cut its RMB26bn issuance by one-third on 17 June.
- The yield on top-rated commercial banks' six-month debt was 4.96% on 19 June, the highest since 2011.
- Cross-border capital flows may have reached a turning point. May FDI grew 0.29% y-o-y, much lower than the average of 13.4% for the same period since 2010, and the contribution from the US declined 24% y-o-y, a 95% m-o-m drop.

The money markets stabilised on 21 June when the seven-day repo rate closed at 5.5%, having closed the previous day at 11.2%, but the liquidity situation remains uncertain. On 23 June the PBoC reiterated that it will implement a "prudent" monetary policy, a description it has used since 2010 (source: Bloomberg).

Figure 1. Spike of interbank interest rate



Source: CEIC, HSBC

Why is the PBoC wary of pumping liquidity into the system?

China's central bank has been cautious about pumping money into the financial system. Instead of lowering the reserve requirement ratio, cutting interest rates or conducting reverse-repurchases – as the market expected – the PBoC chose to tighten the tap further.

On 20 June it issued RMB2bn of T-bills to take more liquidity out of the system. Some liquidity (unofficially estimated at RMB50bn) was released by Industrial and Commercial Bank of China (ICBC), the world's largest commercial bank by market capitalization, on the same day. The market suspected that this came at the direction of the central bank, which had no comment, but the amount was far too small to meet the market's demand for liquidity (source: China Business News).

What the PBoC appears to be doing is to start to address the real problem – the misallocation of credit in China. We first raised this issue in our November 2011 report *China's Contradiction: How excess liquidity co-exists with a credit crunch* and raised it again in *China's growing pains* (16 May 2013).

China is not short of credit – but the challenge is to get it to the right parts of the economy. There has been a credit boom since 2008 when the government announced a huge stimulus package to mitigate the effects of the global financial crisis. As a result, TSF – the government's broadest measure of credit – is 60% higher than it was a year ago, when it was already high (see *China's great balancing act*, 4 February 2013).

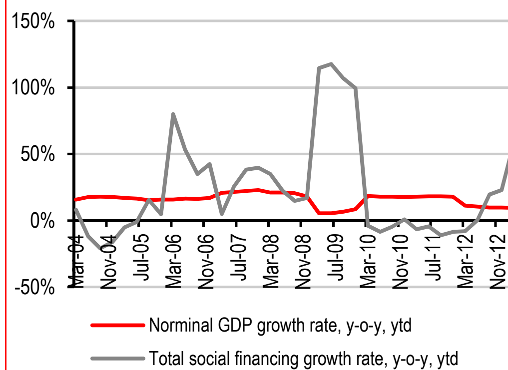
The central bank has a balance sheet of cUSD5trn, more than the EU's cUSD4trn and the US Fed's cUSD3trn. And broad money supply (M2) is about cUSD15trn, higher than the US, despite China's GDP being only slightly over half that of the US.

But all this pump-priming did not bring down borrowing costs. The massive funding needs of local governments and property developers, and loss-making state-owned industrial sectors, such as steel, coal and cement, gobbled up most of the credit.

Collectively, along with speculative funds that have little effect on the economy, they crowded out credit flows to places where money was needed most, especially small and medium-sized enterprises (SMEs) and the private sector in particular. That's why credit expansion has had an increasingly weak effect on the real economy (Figure 2).

As HSBC's Chief Economist Stephen King wrote in the *Financial Times* on 21 June: "Following a period of weak data, there is no longer the guarantee of a Pavlovian knee-jerk pump-priming response. The message is clear: Beijing is increasingly concerned about the quality, not the quantity, of growth."

Figure 2. Growth of total social financing vs. GDP



Source: CEIC, HSBC

Misallocation of credit has also raised risks in China's financial system. First, a big portion of local government investments may have gone to low-return projects such as infrastructure, raising the default risk of local government debt.

Second, in response to stringent regulatory controls and capital requirements, off-balance sheet financing (generally described as shadow banking) has grown rapidly, incentivised by greater returns from risky lending. For example, the boom in wealth management products (WMP) and trusts has raised large amounts of capital but there are now risks of defaults.

Thirdly, excess liquidity has led banks to increasingly rely on short-term interbank financing to roll over their longer-term loans in order to maximise returns.

These factors have significantly increased leverage levels in China's credit system. The PBoC's determination to deleverage suggests that growing concerns about risks in the financial system now outweigh concerns about GDP growth.

Deleveraging and the regulators

With China's new leaders showing more tolerance to a slowdown in GDP, financial regulators are joining the central government in efforts to restructure the economy.

In March the China Banking Regulatory Commission (CBRC) introduced measures to force trust funds and distributors of WMPs to shift assets into publicly traded securities, reducing property developers' and local government finance vehicles' (LGFV) access to shadow banking funds.

Meanwhile, the State Administration of Foreign Exchanges (SAFE) has cracked down on cross-border money flows, as reflected in the recent sharp decline of China's exports.

In the capital market, the China Securities Regulatory Commission (CSRC) has started investigations into misconduct by debt and equity issuers and intermediaries.

This is in line with repeated calls by Prime Minister Li Keqiang to support the real economy by making more efficient use of existing funding rather than creating more credit.

We believe this is what's needed to resolve China's credit contradiction, whereby excess liquidity co-exists with a credit crunch. Beijing has made a commitment not to reflate its economy via fresh rounds of fiscal or monetary easing, signalling a move away from the infrastructure-led growth model. We think this shows that Beijing is being pro-active in addressing the financial risks in its domestic economy.

But this is not solely a domestic issue. The rapid rise in the US dollar and US Treasury rates due to the Federal Reserve's talk of tapering asset purchases and eventually exiting its massive monetary easing programme could put more near-term pressure on liquidity conditions in China. Already, yields of the benchmark US 10-year and 30-year bonds have shot up 90bp and 80bp, a price decline of USD7 and USD13, respectively. All Asian currencies except the renminbi have depreciated against the US dollar as funds started to pull out of emerging markets. For example, emerging market debt-dedicated funds monitored by EPFR Global incurred investor redemptions of USD2.6bn last week alone.

We now look at three areas of China's credit system where pressure points could emerge.

1 Credit risk from money flows

The authorities have been successful in cracking down on cross-border money flows. Essentially, mainland companies were overstating the value of their export shipments to take advantage of profitable interest-rate arbitrage according to

China Business News; detailed examples of how cross-border funding arbitrage works appear in the appendix of this report).

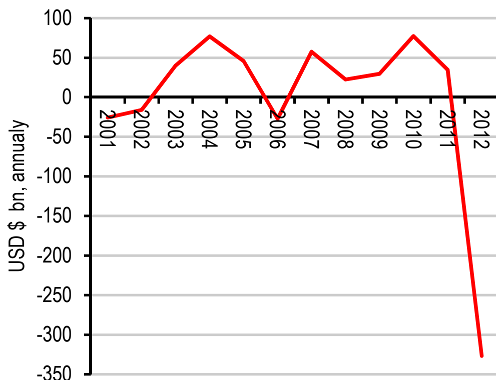
But first some background. In mid-2012 the RMB depreciated nearly 2% against the USD over a six-month period. This led to a build-up in RMB depreciation expectations and resulted in record high capital outflows of USD327bn (Table 1 and Figure 3).

Table 1. Composition of capital inflows in China 2012 (USDbn)

Foreign trade surplus	231.1
Direct net capital inflows	34.5
Income of investment abroad	143.8
Financing of cross-listing	16
Total	425.4
Foreign exchange reserves increment	98.7
Capital inflow	-326.7

Source: State Administration of Foreign Exchange (SAFE), HSBC
Note:
1. Items above are more volatile accounts in China's cross-border capital flow accounts.
2. Capital inflow is calculated as foreign exchange reserves increment minus total.

Figure 3. Change of cross-border capital flows in China



Source: SAFE, HSBC

Once the RMB exchange rate against the US dollar stabilized in late 2012, the cross-border flows quickly reversed as absence of currency risk against the USD made the RMB attractive both in terms of RMB vs USD interest rate differentials and the strength of the USD against other currencies. Strong capital inflows started in late 2012 as onshore RMB lending rates have been higher than USD funding rates offshore. Table 2 shows the estimated inflows for 1Q13.

Table 2. Composition of capital inflows, Jan-Mar 2013 (USDbn)

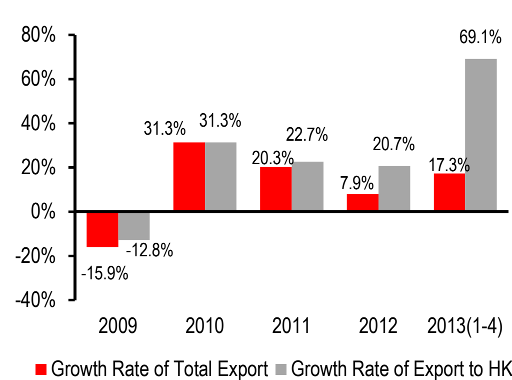
Foreign trade surplus	43.1
Direct net capital inflows	6.1
Income of investment abroad	36.0
Financing of cross-listing	0.8
Total	85.9
Foreign exchange reserves increment	131.1
Capital inflow	45.1

Source: SAFE, Ministry of Commerce, Bloomberg, PBoC, HSBC

Irregular exports

The Ministry of Commerce acknowledged the problem of irregular exports in a press release on 16 May 2013. Despite the deceleration in China's growth and weak external demand, total exports for the first four months in 2013 grew 17.3% y-o-y, up from 7.9% in 2012 (Figure 4). Over the same period exports to Hong Kong surged nearly 70% y-o-y, well out of sync with previous data points. The numbers for March and January were particularly notable – up 93% and 88% y-o-y, the highest growth rates in ten years.

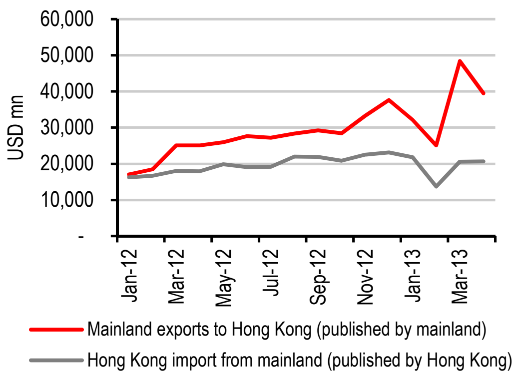
Figure 4. Growth rate of exports to Hong Kong is well above growth rate of total exports in 2012 and 2013 ytd



Source: CEIC, HSBC

In addition, the export figures released by Hong Kong and China did not tally (Figure 5). In April the figure released by the mainland was almost double the Hong Kong Government's number, suggesting that only half of the goods exported from China to Hong Kong actually arrived. With exports to Hong Kong accounting for 21% of China's total exports for the first four months of 2013, these discrepancies can have a significant impact on the quality of China's trade figures.

Figure 5. Discrepancy between mainland's export data and Hong Kong's import data



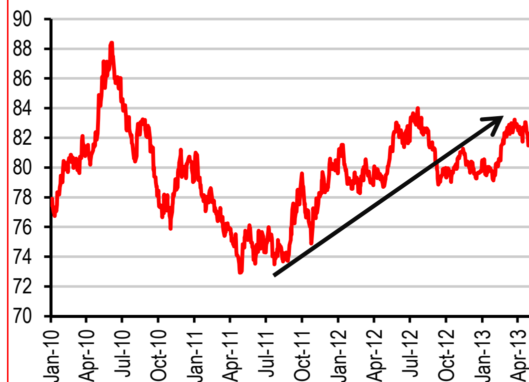
Source: CEIC, Census and Statistics Department of Hong Kong Government, HSBC

The surge in these questionable exports coincided with a rise in the RMB exchange rate from March to May at a time when GDP growth was slowing and the trade surplus shrinking (Figure 6). Despite the absence of strong fundamental support, the RMB is the only major currency to have recently strengthened against the USD (Figure 7).

Figure 6. RMB appreciation has accelerated since March 2013, despite slowing GDP and sovereign rating downgrade

Source: Bloomberg, HSBC
Note: Data as of 15 May 2013

Figure 7. USD Index performance



Source: Bloomberg
Note: The index is calculated as the geometric average of the changes in a basket of major world currencies versus the USD, including Euro, Canadian Dollar, Swiss Franc, British Pound, Swedish Krona and Japanese Yen. The currencies and their weights are determined by the NY Board of Trade. The higher the index, the stronger USD is.

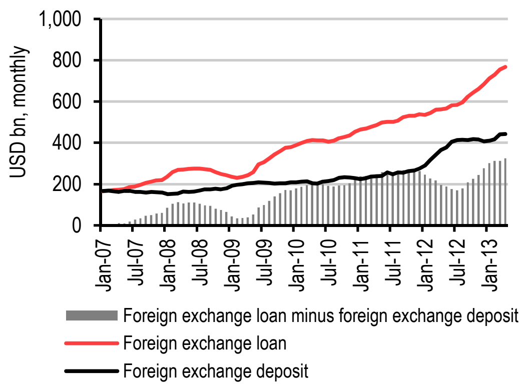
Regulators' response

Beijing responded quickly. In order to mop up the excess liquidity in May the PBoC resumed 91-day T-bill issuance after a break of 17 months.

The PBoC also issued a joint statement with the SAFE in Guangdong province (where the majority of arbitrage activities were based) asking banks to suspend trade-backed financing services with over three-month maturity in order to cut off financing for cross-border arbitrage.

SAFE also issued a notice in May imposing limits on banks' positions in foreign currency loans as strong demand for cheap foreign exchange loans led to a surge in this type of lending, resulting in their foreign exchange loans far exceeding their foreign exchange deposits (Figure 8).

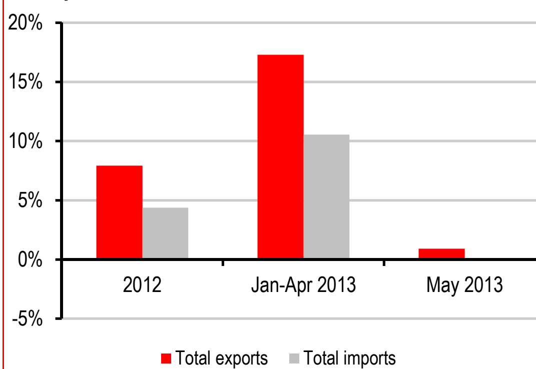
Figure 8. The gap between foreign exchange deposits and foreign exchange loans made by Chinese financial institutions has widened



Source: CEIC, HSBC

The regulators' crackdown has been effective. In May exports grew only 1% y-o-y, down from 17% y-o-y for the first four months in 2013; imports dropped 0.3% y-o-y (Figure 9).

Figure 9. Growth rate (y-o-y) of exports and imports dropped in May



Source: CEIC, HSBC

The credit risks

The irony is that the success in stopping these activities has led to potential credit risks.

First, the banks that provide trade financing are exposed to substantial default risk. Trade financing usually has a maturity of 3-6 months, but arbitragers usually use these short-term loans to invest in longer-term assets such as real estate, trusts or WMPs to earn a higher yield spread, betting on their ability to roll over maturing short-term funding. The unexpected suspension of bank trade financing has caught arbitragers by surprise. Before they can secure funding elsewhere they could be forced to default, passing the credit risks to the banks.

Second, as China's banks are lending more foreign exchange (Figure 8), if the RMB starts to depreciate against the USD, it would raise banks' foreign exchange risks. This may also explain why regulators have been reluctant to use RMB depreciation to discourage cross-border funding arbitrage.

Regulators are caught in a difficult position. Depreciating the RMB could stop hot money inflows and improve China's trade competitiveness amid broad USD strengthening. However, it may also invite unwelcome capital outflows, especially at a time when there is a funding shortage onshore.

2 WMPs: Two issues

WMPs, offered by banks to retail investors looking for higher interest rates, have proved to be extremely popular. However, signs of credit risks are emerging on two fronts – delayed payments for WMPs and the increasing funding dependence on these products by small city commercial banks. We look at these one at a time.

Delayed payments

Although the majority of WMPs are offered without principal guarantees (Figure 10), they are sold to retail savers as alternatives to regular deposits. This has led to rapid growth – from 6,000 WMPs issued in 2008 to more than 30,000 in 2012 (Figure 11).

Recent cases of payment delays are shown in Table 3. In the case of Huaxia Bank, a WMP distributor, protests took place at its branches, not the third-party guarantor or defaulting borrower. Huaxia liaised with relevant parties to pay back the full principal to all investors. This was the result of pressure from investors, media and regulators. So far no bank reserves have been set aside to hedge potential WMP defaults.

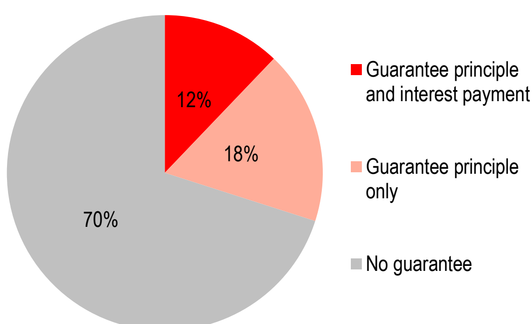
Table 3. Cases of payment delay

Banks/institutions involved	Details
Huaxia Bank	Huaxia Bank distributed a WMP issued by an asset management firm. The WMP was 100% guaranteed by Zhongfa Investment Guarantee Co. The issuer defaulted in November 2012, and investors protested at Huaxia Bank. After two months of negotiations the guarantee company paid investors their principal in full in January 2013. The funds raised from the WMP were invested in pawnshops, automobile sales companies and business clubs*.
Bank of Communications	In May 2013, investors filed a complaint over a RMB1bn WMP issued by Bank of Communications with the CBRC. This WMP does not guarantee principal, but investors requested a full refund because their money was not invested in assets as shown in the product's marketing documents. Moreover, investors were reportedly misled by sales people who verbally guaranteed at least 20% return while the product incurred 20% loss*.
Beijing DaGuanYan Investment Fund	RMB45m due in March 2013 would be settled by two instalments in June and August 2013. Another RMB80m is due in June 2013. The money was invested in coal companies*.

*Source: China Business News, International finance news, HSBC

Another concern is that WMP funds are exposed to increasingly exotic assets that the issuer may not have the expertise to manage. For example, *Xinhua* and *China Business News* have reported cases that include WMPs investing in physical commodities such as Chinese ham, tea and watches. Competition is driving issuers to engage in higher risk investment in pursuit of higher returns, raising credit risks.

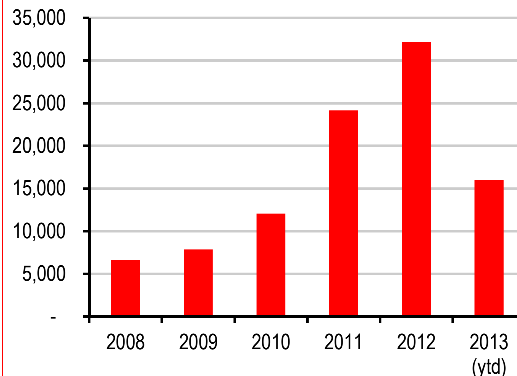
Figure 10. Breakdown by types of guarantees



Source: Wind, HSBC

Note: data based on 10,662 WMPs due from June to Dec 2013

Figure 11. WMPs issuance has grown rapidly



Source: Wind, HSBC

Note: data as of 13 June 2013

Commercial banks

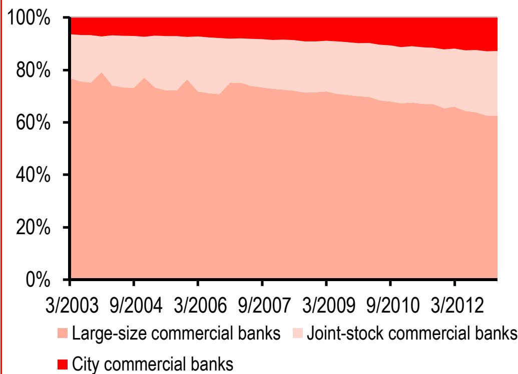
City commercial banks are generally the smallest and least well capitalised banks of the four-major types of commercial banks in China. But their numbers are growing and they are becoming an increasingly significant part of China's banking system.

As of March 2013, they held 13% of the total assets of China's banks, up from 6% in March 2003 (Figure 12). In 2012, the listed Bank of Beijing became the first city commercial bank with total assets of over RMB1trn, putting it in the same league as joint-stock banks such as Huaxia Bank and Ping An Bank.

WMPs are becoming a major source of funds for these banks. The problem is that they have less sophisticated risk management systems in our view than the big banks, making them more vulnerable to potential risks.

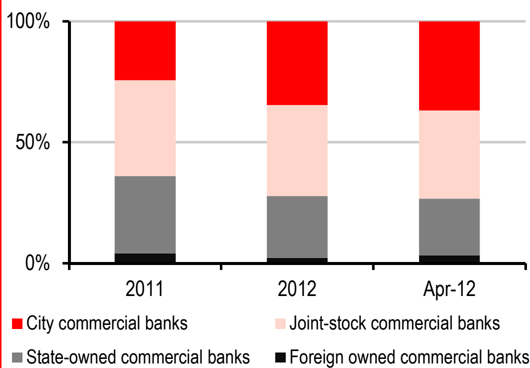
In April 2013 these banks became the biggest issuers of WMPs, overtaking the joint-stock banks. In May, city commercial banks issued 902 WMPs, 36.9% of the total issued; 36.4% were issued by joint-stock banks and 23.4% by state-owned banks (Figure 13).

Figure 12. Breakdown of Chinese banks' total assets, quarterly



Source: Wind, HSBC

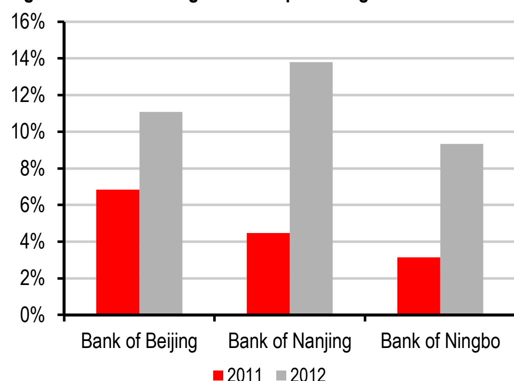
Figure 13. Shares of the number of WMPs issued by four types of banks in China



Source: Bankrate.com.cn, HSBC

WMP assets as a percentage of total assets for the three listed city commercial banks jumped in 2012, accounting for 11%, 14% and 9% of total assets for Bank of Beijing, Bank of Nanjing and Bank of Ningbo, respectively (Figure 14).

Figure 14. Outstanding WMPs as percentage of total assets



Source: Bank Annual Reports, HSBC

What's behind the surge

A CBRC regulation published in March 2013 (Notice about Regulating Commercial Banks' WMP Operation, or "Regulation 8") that aimed to control WMPs has in fact had the opposite effect.

Regulation 8 requires the amount of "non-standard" debt assets – those not traded in the interbank market or securities exchange – to be lower than 35% of total WMPs and 4% of the bank's total assets.

City commercial banks have less access to traditional sources of banking revenue and greater need for growth than the larger joint-stock and state-owned banks. This means they are more reliant on WMPs and have more incentive to increase the number of WMPs issued.

Mutual investment and accounts receivables

WMPs, bonds and trusts held on a bank's balance sheet are classified as "accounts receivable investments" for the investing bank. Compared to the big-four banks and joint-stock commercial banks, city commercial banks have been allocating more assets to accounts receivable assets than other financial institutions since 2012 (Figure 15).

WMPs and trust products are becoming the dominant asset class, accounting for over 85% of total accounts receivable products for the three listed city commercial banks (Figure 16). This means that these banks are indirectly lending by buying other banks' assets. In this sense, they are playing an ever bigger role in China's lending system, and their higher risk profile could put more stress on the country's credit market.

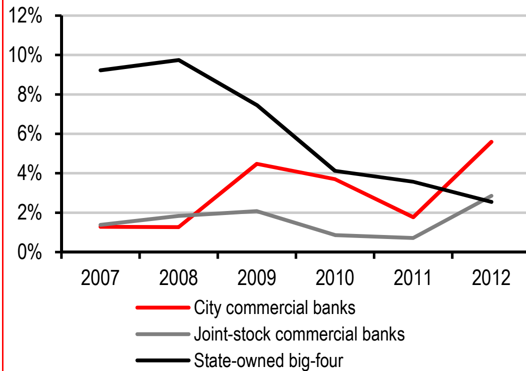


Figure 15. Amount of investment in accounts receivable assets as percentage of total assets for the 16 listed Chinese banks

Source: Wind, HSBC

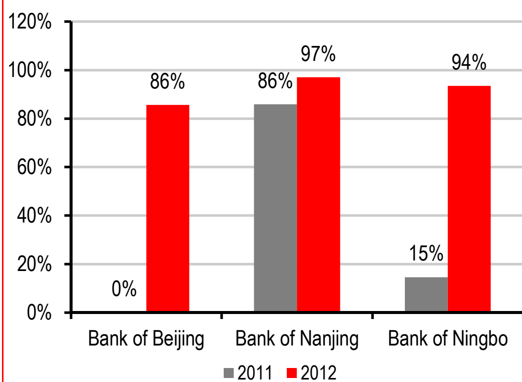


Figure 16. Percentage of WMPs and trust products in total accounts receivable products investment for three listed city commercial banks

Source: Bank Annual Reports, HSBC

3 Third-party lending

Third-party lending, which involves corporations providing credit or guarantees to each other, is on the rise. Unlike bank loans, this type of lending is unregulated, undercapitalised and lacks transparency.

Although China has achieved a soft landing from a macro perspective, it's been a different story at the corporate level since 2010 as both sales and profits have declined rapidly (Figure 17).

Cash-strapped companies that run negative cash flows, usually with implicit government support, are keen to seek funding at interest rates that are well above benchmark rates now that banks are less likely to lend to risky borrowers. This in turn creates incentives for businesses with thin operating margins to boost earnings by making high-interest third-party loans.

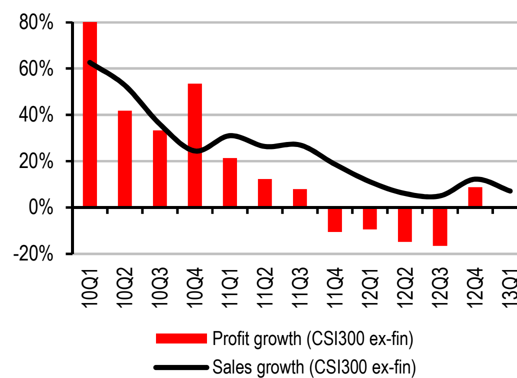


Figure 17. Economic soft landing, but not for corporate sales and profits

Source: Wind, HSBC

Mutual guarantees

Intra and inter-company mutual guarantees are common practice in China. Figure 18 shows that mutual guarantees provided by A-share listed companies have been on the rise since 2009[1]. The number of guarantee loans rose from 2,812 in 2004 to 5,510 in 2012, with the average guarantee amount per loan rising from RMB3m in 2004 to RMB6.9m in 2012.

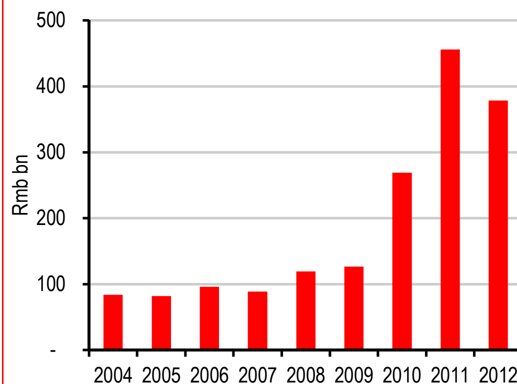


Figure 18. Amount of guarantees that A-share listed companies provide for other Chinese companies

Source: Wind, HSBC

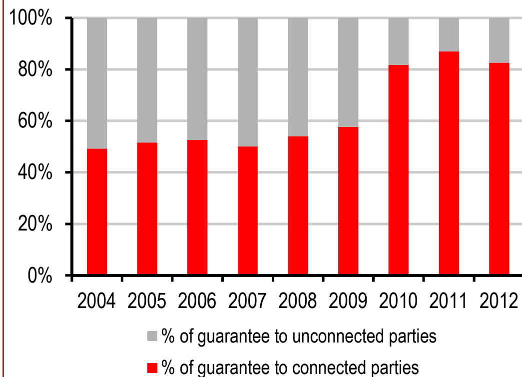
[1] Due to public disclosure constraints, we only focus on listed companies, although these loans are also common practice for non-listed ones.

Connected vs. unconnected parties

Mutual guarantees generally involve connected companies, including the parents of listed companies, subsidiaries or associated companies. The percentage of guarantees going to connected companies has grown from 54% in 2008 to 83% in 2012 (Figure 19).

It is also common for a company that acts as a guarantor to many other businesses to simultaneously receive multiple guarantees from other entities. These reciprocal arrangements raise the systemic risk of mutual guarantees.

Figure 19. Percentage of guarantees by A-share listed companies to connected parties increases since 2009

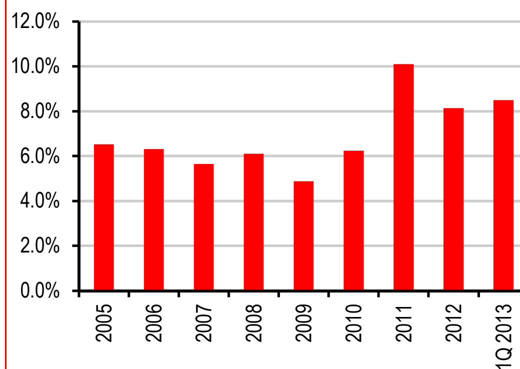


Source: Wind, HSBC

Entrusted loans

Entrusted loans, which are direct loans usually between listed and unlisted corporates, are becoming a larger part of China's TSF, a broad measure of system liquidity. According to the PBoC, between 2005 and 2010 entrusted loans represented about 6% of TSF which increased to over 8% in 2011, 2012 and 1Q13 (Figure 20). (Entrusted loans reached a peak of 17% of TSF in February 2012.)

Figure 20. Entrusted loans as percentage of total social financing



Source: CEIC, HSBC

Entrusted loans are popular with customers who have urgent financing needs but limited access to bank loans or capital markets. LGFVs and small property developers fall into this category.

The CBRC has asked banks to reduce existing loans and control new loans to LGFVs for three consecutive years. Property price controls have also made it difficult for small property developers to get bank loans. The reality is that LGFVs and small property developers have no choice but to turn to alternative financing sources.

Providing there are no defaults, entrusted loans look like a "win-win" situation. Cash-strapped businesses get financing and listed companies make extra money.

But LGFVs and small property developers are risky borrowers. To compensate for the risk, the entrusted loans typically come with very high interest rates. For example, a RMB17m entrusted loan made by Henan Zhongyuan Expressway to a local property developer charged rates as high as 25.95% according to the company's Annual Report. These levels of interest rates further increase the risk of defaults.

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Appendix: Cross-border arbitrage – typical examples

Interest rate arbitrage

The higher onshore interest rate makes it profitable to borrow offshore USD and then lend onshore RMB to benefit from the interest rate spread (Figure 21). The simplest way to do so is through export financing:

- An onshore business exports goods to its offshore equivalent.
- The export contract is used to apply for a letter of guarantee from an onshore bank.
- The RMB borrowed onshore is then put in the onshore bank in the form of a time deposit or WMP as collateral for the bank's letter of guarantee.
- Using the letter of guarantee, the company can then borrow offshore USD from an offshore bank.
- The company converts offshore USD into onshore RMB. It can repeat the arbitrage trade from the beginning.
- When the USD loan matures, the arbitrager uses the onshore RMB that was pledged to buy USD in order to pay back the USD loan.
- The arbitrager can either enter an exchange rate forward contract to hedge fluctuations between USD and RMB, or assume the exchange rate risk if it expects the RMB to continue to appreciate.

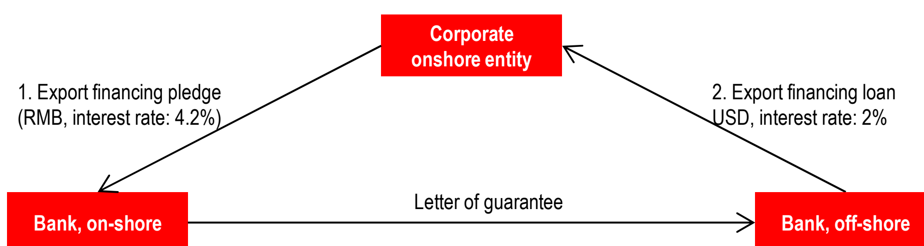
Import financing

Import financing is slightly more complicated but can serve the same purpose as borrowing offshore and lending onshore, as below:

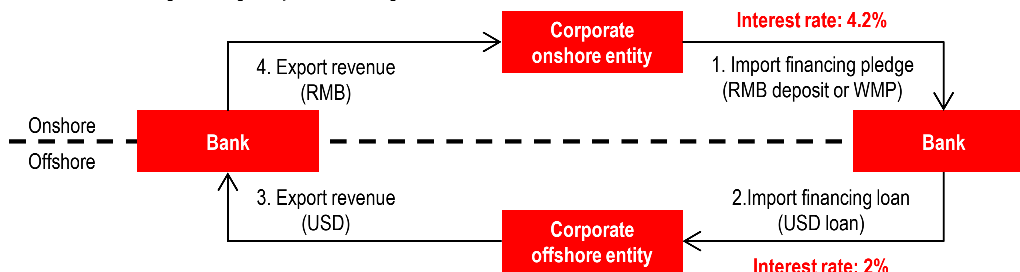
- An onshore business imports goods from its offshore equivalent.
- The import contract is used to apply for a letter of credit from an onshore bank.
- The RMB borrowed onshore is then put in the onshore bank in the form of a time deposit or

Figure 21. Interest rate arbitrage

Interest rate arbitrage through export financing



Interest rate arbitrage through import financing



Source: HSBC

WMP as collateral to get a letter of credit from the bank.

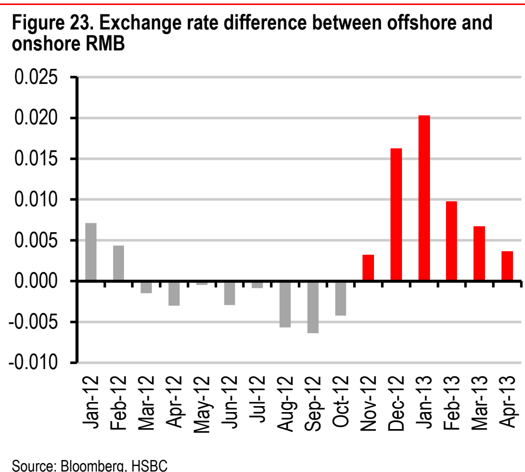
- Using the letter of credit, the company can then borrow offshore USD from an offshore bank.
- Once the company's offshore entity gets the USD loan, its onshore business exports the goods to its offshore entity, through which the loan can be exchanged into onshore RMB.
- The onshore RMB loan is then repaid, with the profit being the interest rate spread between the onshore WMP and the offshore loan.

Onshore vs offshore RMB arbitrage

Interest rate arbitrage is making the conversion of USD loans into RMB an increasingly attractive corporate transaction. This is not only pushing up the RMB exchange rate but also makes offshore RMB more expensive than onshore RMB (Figure 22). The gap between the two rates can be used for RMB arbitrage (Figure 23), as follows:

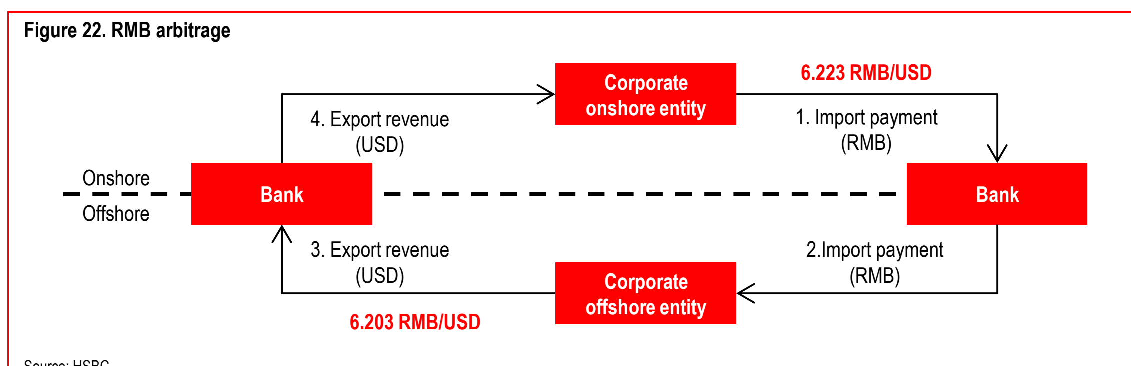
- First, borrow USD onshore and convert it into RMB at the onshore exchange rate.
- Then convert it into offshore RMB; this is done by a company using its onshore entity to pay its offshore business for imports.
- Then convert the offshore RMB into USD at the lower offshore exchange rate.
- Shift the USD back onshore through exports from an onshore entity to its offshore business.
- Then repay the USD loan and make a profit from the difference in the exchange rate.

Figure 23. Exchange rate difference between offshore and onshore RMB



Source: Bloomberg, HSBC

Figure 22. RMB arbitrage

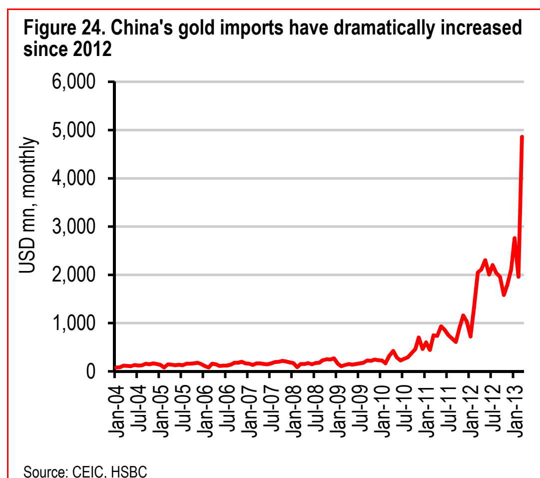


Source: HSBC

Increasing returns

Another alternative is to export and import the same shipment several times, which increases the returns. Delivery costs are kept low by using high value-added goods which are cheap to deliver, such as gold or precious stones. China's gold exports jumped 135% in 2012 (Figure 24) and the growth rate for 1Q13 was 134%.

Figure 24. China's gold imports have dramatically increased since 2012



Source: CEIC, HSBC

Hong Kong, as the nearest port and financial centre, is the most popular offshore location for arbitragers. Export and imports of pearls, precious stones and metals to and from Hong Kong in 1Q grew 128% and 88% y-o-y, respectively (Tables 4-5).

This exercise sometimes does not even involve any shipments of goods. According to *Xinhua*, *People Net* and *South China Morning Post*, questionable export and import contracts can allow companies to make cross-border financial transfers without having to make any shipments. This could help to explain why the Hong Kong and mainland export numbers do not match.

Table 4. Top-5 sectors by growth rate of exports to HK

Sectors	Growth rate of exports to HK	Weight in total exports to HK
Works of art, antiques	414%	0%
Commodity not classified according to kind	330%	0%
Pearls, precious stones and metals	128%	9%
Electrical machinery and equipment	116%	30%
Optical, photographic, musical instruments	99%	4%

Source: CEIC, HSBC

Table 5. Top-5 sectors by growth rate of imports from HK

Sectors	Growth rate of imports to HK	Weight in total imports to HK
Pearls, precious stones and metals	88%	5%
Commodity not classified according to kind	83%	38%
Footwear, headgear, umbrellas	25%	0%
Mineral products	18%	2%
Mineral fuel, mineral oil & products	17%	2%

Source: CEIC, HSBC

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Disclosure appendix

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Issuer of report
The Hongkong and Shanghai Banking Corporation Limited
Level 19, 1 Queen's Road Central
Hong Kong SAR
Telephone: +852 2843 9111
Telex: 75100 CAPEL HX
Fax: +852 2801 4138
Website: www.research.hsbc.com

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HSBC

Global Fixed Income Research Team

Steven Major, CFA
Global Head of Fixed Income Research
+44 20 7991 5980 steven.j.major@hsbcib.com

Rates

EMEA

Bert Lourenco
Head of Rates Research, EMEA
+44 20 7991 1352 bert.lourenco@hsbcib.com

Subhrajit Banerjee
+44 20 7991 6851 subhrajit.banerjee@hsbcib.com

Theologis Chapsalis
+44 20 7992 3706 theologis.chapsalis@hsbcib.com

Wilson Chin, CFA
+44 20 7991 5983 wilson.chin@hsbcib.com

Di Luo
+44 20 7991 6753 di.luo@hsbcib.com

Chris Attfield
+44 20 7991 2133 christopher.attfield@hsbcib.com

Johannes Rudolph
+49 211 910 2157 johannes.rudolph@hsbc.de

Sebastian von Koss
+49 211 910 3391 sebastian.von.koss@hsbc.de

Asia

André de Silva, CFA
Head of Rates Research, Asia-Pacific
+852 2822 2217 andre.de.silva@hsbcib.com

Pin-ru Tan
+852 2822 4665 pinrutan@hsbc.com.hk

Himanshu Malik
Associate
+852 3941 7006 himanshu1malik@hsbc.com.hk

Americas

Larry Dyer
+1 212 525 0924 lawrence.j.dyer@us.hsbc.com

Jae Yang
+1 212 525 0861 jae.yang@us.hsbc.com

Pablo Goldberg
Head of Global Emerging Markets Research
+1 212 525 8729 pablo.a.goldberg@us.hsbc.com

Bertrand Delgado
EM Strategist
+1 212 525 0745 bertrand.j.delgado@us.hsbc.com

Gordian Kemen
Chief Strategist, LatAm Fixed Income
+1 212 525 2593 gordian.x.kemen@us.hsbc.com

Victor Fu
+1 212 525 4219 victor.w.fu@us.hsbc.com

Alejandro Mártinez-Cruz
+52 55 5721 2380 alejandro.martinezcr@hsbc.com.mx

Credit

EMEA

Lior Jassur
Head of Credit Research, EMEA
+44 20 7991 5632 lior.jassur@hsbcib.com

Dominic Kini
+44 20 7991 5599 dominic.kini@hsbcib.com

Laura Maedler
+44 20 7991 1402 laura.maedler@hsbcib.com

Anna Schena
+44 20 7991 5919 anna.schena@hsbcib.com

Pavel Simacek, CFA
+44 20 7992 3714 pavel.simacek@hsbcib.com

Reza-ul Karim
+44 20 7992 3703 reza-ul.karim@hsbcib.com

Raffaele Semonella
+971 4423 6554 raffaele.semonella@hsbcib.com

Asia

Dilip Shahani
Head of Global Research, Asia-Pacific
+852 2822 4520 dilipshahani@hsbc.com.hk

Zhiming Zhang
+852 2822 4523 zhimingzhang@hsbc.com.hk

Devendran Mahendran
+852 2822 4521 devendran@hsbc.com.hk

Philip Wickham
+65 6658 0618 philipwickham@hsbc.com.sg

Keith Chan
+852 2822 4522 keithkfchan@hsbc.com.hk

Louisa Lam
+852 2822 4527 louisamclam@hsbc.com.hk

Yi Hu
+852 2996 6539 yi.hu@hsbc.com.hk

Helen Huang
+852 2996 6585 helendhuang@hsbc.com.hk

Crystal Zhao
+852 2996 6514 crystalmzhao@hsbc.com.hk

Alex Zhang
+852 2822 3232 alexdzhang@hsbc.com.hk

Kelly Fu
+852 3941 7066 kellyyfu@hsbc.com.hk

Americas

Sarah R Leshner
+1 212 525 3231 sarah.r.leshner@us.hsbc.com