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Instant Thoughts

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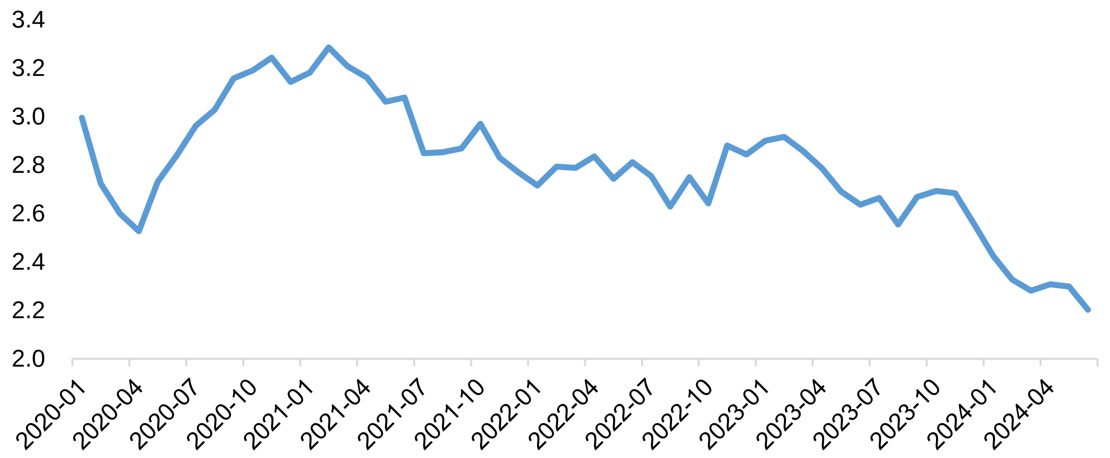
On Borrowed Time

- **PBoC's groundbreaking borrowing CGBs from primary dealers kills two bird with one stone: With periodic renewals, it solves the thorny issue of calibrating the right level of reserves in real time. Even more soothing, when the sovereign replaces banks and shadow banks as the dominant borrower in the wholesale funding markets, tail risks will be curtailed.**
- **The intraday liquidity risk will move back into spotlight if non-bank players return from a strike however.**
- **The untested CGB borrowing, while generating headlines, is best understood as mood music. All yields higher than 2.2% still seems a fair game.**

Treasurers in Mainland China have gorged on CGB for various reasons, be it the epic inflows of deposits or a lack of arbitrage opportunities. Trading CGB with zero risk weight has become their life-saving straw. On this everyone agrees. We just don't agree how to deal with it.

Exhibit 1: 10-year CGB Yield (%)



Source: CEIC, Shanghai Commercial Bank

Proactiveness, vision, and decisiveness are cited as the solution. And these miss the point. If PBoC, riding on a white horse, steps in and simply takes their bond holdings away, banks would have to flood the repo market with elevated reserves to line their own pockets. We will all then feel the impact as even the second-tier banks transform themselves from repo borrowers to repo lenders.

Here's the out-of-the-box idea: PBoC merely borrows CGBs from primary dealers. Unlike the now-fashionable QE, the borrowing is not permanently funded, but financed possibly monthly or even weekly. It kills two bird with one stone: With periodic renewals, it solves the thorny issue of calibrating the right level of reserves in real time. Even more soothing, when the sovereign replaces banks and shadow banks as the dominant borrower in the wholesale funding markets, tail risks will be curtailed. The upsides are clear.

And then you wonder - how will the PBoC police the long-tenored rate? One fact has got lost of late. It takes much collateral drain to dislocate a market with a daily transaction of RMB400-500bn. The intraday liquidity risk will move back into spotlight if non-bank players return from a strike. The untested CGB borrowing, while generating headlines, is best understood as mood music. All yield higher than 2.2% still seems a fair game.

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