FINANCIAL SYSTEM

THE STORY SO FAR

Modern economies rely on complex financial systems to support growth and prosperity. At an earlier stage of development, China succeeded despite an immature financial system, as state-led investments in sectors such as infrastructure generated high returns. Today's requirements are more complicated and risks are apparent. China's financial reform goals include improving efficiency (return on investment) and reducing systemic risk while attempting to preserve state influence. China has made progress, but long-standing tasks remain unfinished as the cost of retiring old liabilities swells, and new risks emerge. The 2013 Third Plenum Decisions promised market-driven liberalization of the system in the form of additional entry opportunities to smaller and private financial institutions, market-driven interest rates and exchange rate formation, and additional capital account liberalization.

- Regarding interest rate liberalization, Beijing removed a floor on lending rates in July 2013. In 2015, Beijing gradually increased the ceilings that banks could offer on deposit rates and then removed them entirely in October 2015. While formal constraints have been lifted, banks continue to limit full market pricing of deposits, reportedly because of informal guidance from regulators.

- Exchange rate liberalization has progressed along a rocky path, as there is still considerable evidence of People's Bank of China (PBOC) intervention into the foreign exchange markets. After a poorly communicated adjustment to the currency's daily fixing mechanism produced a shock depreciation in August 2015, yuan movements have become much more volatile. While markets have a freer hand to adjust the yuan's value, the central bank's intervention is also persistent, reducing benefits of market determination.

- In late 2016, Beijing launched an aggressive deleveraging campaign to reduce systemic financial risks that were accumulating from the growth of shadow banking activities. Despite a slowdown in economic growth, the campaign has continued, substantially reducing credit growth in China and tightening regulations around the financial system.

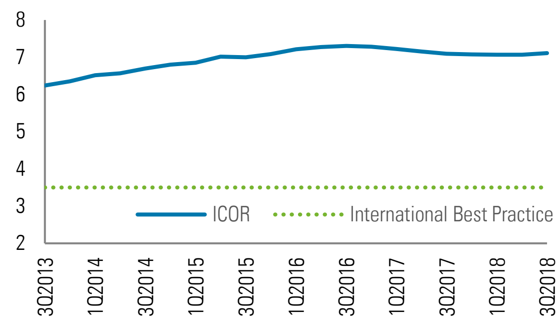
- Foreign investors' participation in China's financial markets has increased, and Beijing is encouraging foreign portfolio inflows in particular, with the expansion of programs such as the Bond Connect and Hong Kong to Shanghai Stock Connect starting in 2015. In 2018, foreign investors were key marginal investors in China's government bond market and exercised significant influence over China's domestic interest rates.

METHODOLOGY

To gauge the state of financial system reform, we construct a quarterly incremental capital output ratio (QuICOR) as an acid test for efficiency; then we discuss the policies giving rise to this picture. The indicator tells us how much investment occurs relative to one unit of output growth: a lower ratio is better, with 3.5 recognized as high quality internationally, according to International Monetary Fund (IMF) guidance. To supplement this analysis, we look at other indicators including total credit growth rates, the ratio of stock and bond financing to less direct channels, interbank lending rates, return of household savings, and foreign bond holdings.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Incremental Capital Output Ratio
4qma, ratio value



Source: National Bureau of Statistics, Rhodium Group.

- Our assessment is neutral this quarter. Our primary indicator of capital efficiency held at 7.1, showing China's financial system is far less efficient than those in other developed economies.

- Beijing's deleveraging campaign within China's financial system continued during the review period. This reduced financial risks on the funding side of banks' balance sheets, but it increased economic risks as less credit flowed to firms and households.

- Money market rates generally fell in 3Q2018, which reduced the attractiveness of shadow banking assets, while a rising proportion of financing was extended formally as loans – all consistent with reform objectives.

THIS QUARTER'S NUMBERS

The primary indicator, the quarterly incremental capital output ratio (QuICOR), remained stable at 7.1 this quarter, well above the 3.5 international standard for capital efficiency. This indicates that even though China's economy and financial system are experiencing slower growth at present, credit is not being allocated more efficiently in terms of generating economic activity. The more efficient private sector is typically squeezed in any slowdown in aggregate credit in China, because state-owned firms have more fixed assets to pledge as collateral and tend to maintain closer political access to state-owned banks. As a result, private sector access to financing has suffered over the past year of deleveraging as overall credit has slowed.

Overall credit growth continued to slow (see **Growth in Credit**), consistent with Beijing's deleveraging campaign to reduce systemic risks within the financial system. Formally, the PBOC's measure of credit growth, total social financing (TSF), fell to 10.6% year-on-year (yoy) in 3Q2018 from 11.1% in 2Q2018 and dropped sharply from 16.6% yoy in 4Q2016. In reality, the slowdown in credit growth was probably sharper than that, as the central bank revised measures of TSF growth that had the effect of boosting the headline data. Bank assets, a broader measure of credit growth, rose by only 7.3% yoy in 3Q2018. The slowdown in credit growth is an essential part of financial reform, as China's financial system has grown much faster than the real economy since the global financial crisis – an untenable situation that generated considerable financial risk.

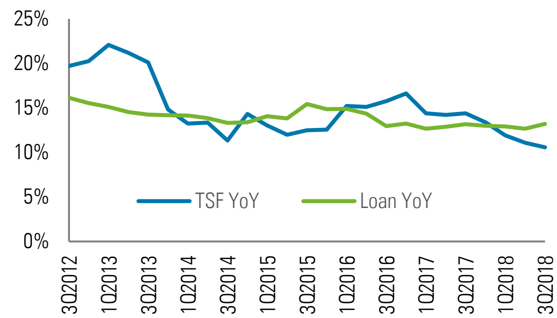
Money market rates declined significantly during the review period, which reduced the attractiveness of informal, or shadow banking, investments. As a result, more financing was extended in the form of loans, which increased from 12.7% to 13.2% in 3Q2018, and corporate bond issuance remained strong as well, despite rising credit risks in that market. Offering rates on Yu'e Bao investments, the country's biggest money market fund that we use as a benchmark in our indicator of financial repression (see **Return on Savings**), dropped to 3.29% in 3Q2018, down from 3.87% the previous quarter. Because most of Yu'e Bao's funds are reinvested into China's money markets, lower interbank money market rates tend to discourage purchases of wealth management products and other alternatives to more stable deposits.

Money market rates for the broader interbank market that includes nonbank financial institutions and shadow banks (see **Interbank Lending Rates**) nearly converged with rates for banks alone, indicating less demand for credit from riskier institutions. One of the final steps toward interest rate reform is the convergence of money market rates (which need to fall) and deposit rates (which need to rise) to channel financing for banks back into safer, deposit-dominated forms. However, deposit rates did not increase during the review period.

Foreign investors' participation in China's financial markets remains extremely low but increased throughout the first half of 2018, and this trend extended in 3Q2018, with the proportion of foreign ownership in China's domestic bond market up to 2.27% in 3Q2018 from 2.18% in 2Q2018. Foreign ownership of China's government bonds in particular has surged, reaching more than 8% of the total market, with some purchases anticipating China's inclusion in global bond indices in the years to come. In October and November 2018, however, foreign bond purchases reversed sharply, most likely due to expectations of currency depreciation.

Supplemental 1: Growth in Credit

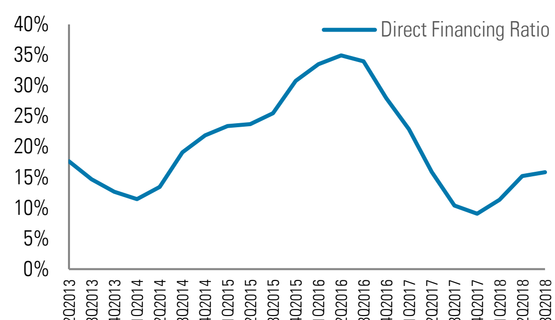
Percent



Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio

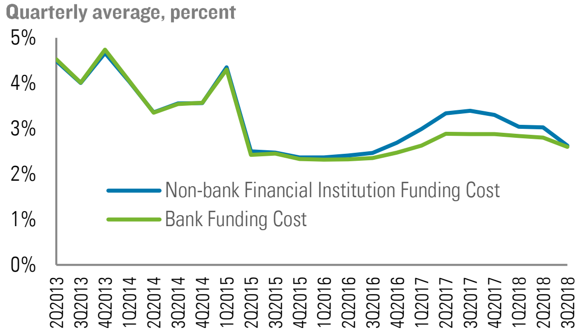
4qma, percent



Source: The People's Bank of China, China Securities Regulatory Commission.

Supplemental 3: Interbank Lending Rates

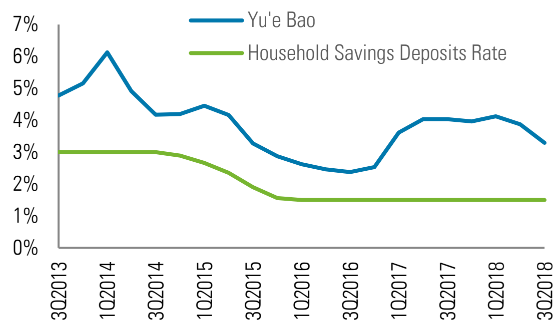
Quarterly average, percent



Source: National Interbank Funding Center; China Central Depository & Clearing Co.

Supplemental 4: Return on Savings

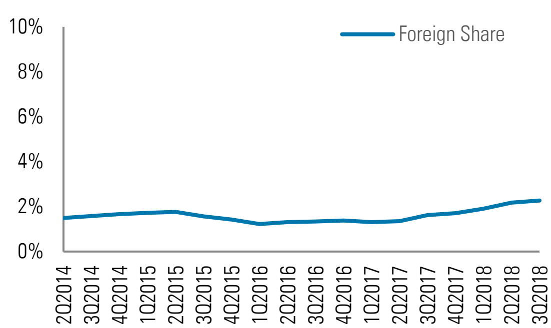
Quarterly average, percent



Source: The People's Bank of China.

Supplemental 5: Foreign Held Bonds

Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

POLICY ANALYSIS

Beijing took significant actions to reduce financial risks over the past two years but took fewer steps to reform the financial system or improve its efficiency. The results of that approach are apparent: as credit growth slowed in 2018, so did the economy. Nonetheless, slowing credit growth is an essential first step in any reform program, and Beijing's efforts successfully moved China's economy closer to an outright reduction in leverage, with credit growth rates very close to nominal GDP growth.

Now, with the economy slowing, Beijing may be tempted to abandon the deleveraging effort in favor of a traditional stimulus. The key area to watch as an indicator of Beijing's intentions is the enhanced regulatory structure that controlled informal financing growth successfully so far this year. All signs are that this new institutional structure, along with some critical asset management product rules implemented in May 2018, will remain in place, even if monetary easing continues in an attempt to stabilize growth.

Monetary-easing steps – including four adjustments to banks' required reserve ratios (RRR) and guidance of money market rates lower in 2018, and an additional RRR cut in January 2019 – do not necessarily indicate that the deleveraging campaign is ending. Lower money market rates are essential to reduce the attraction of shadow banking assets, although they must be paired with tighter regulations at the same time. Ultimately, the central bank's final stage of interest rate reform requires the convergence of money market rates with formal bank deposit rates, to reduce the regulatory arbitrage opportunities giving rise to shadow banking and financial risks. So far, money market rates have declined, but deposit rates have not fully converged.

A broader concern is the inability of policy measures to improve the efficiency of the financial system operating at a slower pace of credit growth. Funding for more efficient and dynamic private sector firms remained a key problem in 2018, as the slowdown in credit growth privileged state firms. One attempt to solve that via diktat – banking regulator Guo Shuqing's November 2018 comments that 50% of new loans should go to private businesses over the next three years – was widely dismissed as unworkable, and potentially risky, given banks' inability to evaluate credit risk systematically among private firms. More fundamental issues limiting private sector lending include long-standing institutional preferences for lending to state-owned enterprises, limited access to collateral, and the lack of sufficient net interest margins in private lending to compensate for the risks; interest rate cuts focused on reducing bank funding costs would assist this process.

Foreign bond market participation slowed in late 2018 because of the looming threat of yuan depreciation as the central bank aggressively defended the yuan during a period of U.S.-China negotiations at the G20 summit in Buenos Aries in late November. Should the yuan weaken to a more attractive valuation, this would likely extend 2018's aggregate surge in foreign ownership in China's government bond market, given continued anticipation of China's inclusion in global bond indices in the years ahead.