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, RMB movements have become much more volatile. While markets have a freer hand to adjust the RMB'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.

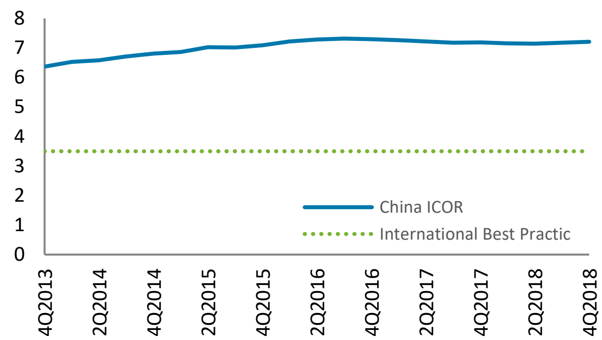
- Foreign investors' participation in China's financial markets has increased, and Beijing is encouraging foreign portfolio inflows in particular, with the expansion of programs such as the Bond Connect and Hong Kong to Shanghai Stock Connect starting in 2015. In 2018, foreign investors were key marginal 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 shows the financial system is becoming marginally less efficient in generating growth, despite leadership pledges of reform.

- Overall credit growth continued to slow in 4Q2018 — a critical precondition for a more stable and sustainable financial system — while direct corporate financing from the bond market (rather than banks) increased.

- Moves toward liberalization in the financial sector are occurring rapidly to maintain and grow foreign investment flows into fixed income and equity markets, as well as lifting restrictions on foreign participation in the brokerage and insurance sectors.

THIS QUARTER'S NUMBERS

Analysts look to China's financial system for evidence that a return to reform is taking hold because Chinese officials have been focusing more on financial reforms than on any other area of policy change. That focus included the deleveraging campaign over the past two years and talk of wider opening to private and foreign investment and market competition. However, we judge the outcome in financial system reform not by pledges but by their implementation, and whether this improves financial efficiency. Despite all the pledges for financial system reform, through the fourth quarter of 2018, financial markets were still becoming *less* efficient. Our primary indicator — an incremental capital output ratio — slid to 7.21 from 7.17 in the fourth quarter: more than twice as much capital required to get the same output growth as in best-practice nations. Beijing clamped down on shadowy finance more earnestly than ever last year but still did not achieve reform goals of making financial markets more open and efficient. This is the legacy of large existing debt levels, but also because politics continue to trump market forces in allocating credit. Returns continue to be low.

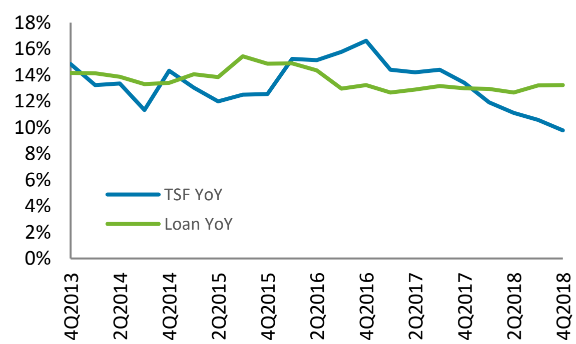
Overall **Growth in Credit** continued to slow, consistent with the campaign to reduce systemic financial risk. The PBOC's formal measure of credit growth, total social financing (TSF), fell to 9.8% year-on-year (yoy) in 4Q2018 from 10.6% in 3Q2018, down sharply from 16.6% yoy in 4Q2016. In reality, the slowdown is even steeper, as China's shadow banking system — some components of which are not captured within TSF — contracted. This is an essential part of financial reform, as financing had grown much faster than the real economy since the global financial crisis — an untenable situation that generated major risk.

While foreign investor presence in China increased in 2018, led by rising purchases of government and policy bank bonds, its role remains extremely small. Surprisingly the rise of foreign bond ownership we noted previously flatlined in 4Q2018, dropping slightly to 2.24% from 2.27% in 3Q2018. Currency risks were the primary factor, as the central bank increased intervention in the foreign exchange market late in the year to defend the currency's value and keep the RMB below 7.0 per dollar. Expectations of currency weakness tend to reduce inflows into China's bond and equity markets. However, China's inclusion in some global bond indices in 2019 is likely to drive inflows this year, an outcome Chinese officials look forward to and regulators are attempting to promote by permitting new hedging instruments. We discuss foreign flows into China's equity and bond markets in the **Investment** cluster.

In any slowdown in credit growth in China, the private sector is squeezed relative to state firms, because state-owned enterprises (SOEs) have more fixed assets to pledge as collateral and have generally closer ties to state banks. While that pattern was evident in 2018, by year-end, data showed private-enterprise-heavy provinces sustaining more credit growth than many SOE-led provinces. Data released by the central bank showed that the more dynamic coastal provinces, such as Zhejiang and Guangdong, were seeing credit growth at more than twice the pace of the rest of the country, while some interior provinces saw hardly any new credit growth in 2018. After the difficulties the Chinese private sector endured in 2018, it will take more than a few quarters to establish confidence that Beijing is ready to pay more than lip service to leveling the playing field. But this trend does bear watching.

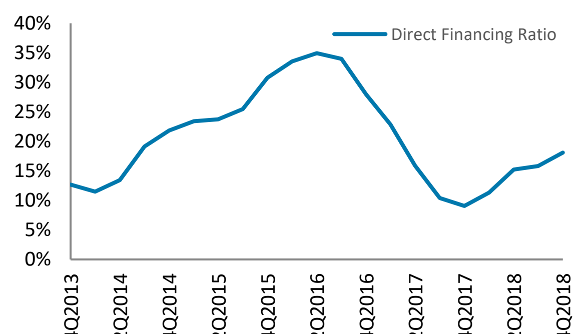
Money market rates declined significantly during the review period as the PBOC eased monetary policy to boost growth. This made risky shadow banking investments less attractive relative to more standard products. More financing was extended in the form of loans, and lower money market rates also incentivized corporate bond issuance, despite rising default risks in that market. This was exactly the goal of easing. 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 only 2.6% in 4Q2018, down more than 120 basis points in six months. This low-rate environment helps avoid more defaults in China, since it is easier for borrowers to cover their enormous debt service obligations. A shift in Washington away from raising U.S. interest rates in 2019 makes it easier for Beijing to keep its own rates lower, because there is less concern that capital will chase higher rates abroad.

Supplemental 1: Growth in Credit
Percent



Source: People's Bank of China.

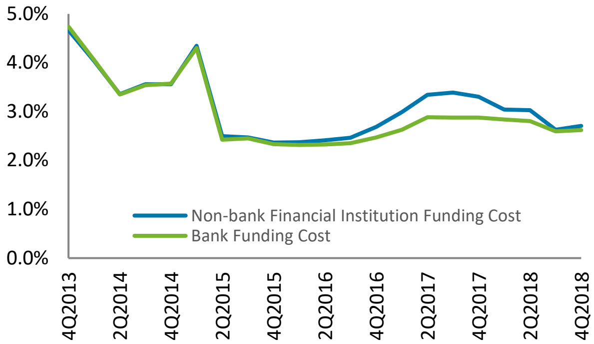
Supplemental 2: Direct Financing Ratio
4qma, percent



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

Supplemental 3: Interbank Lending Rates

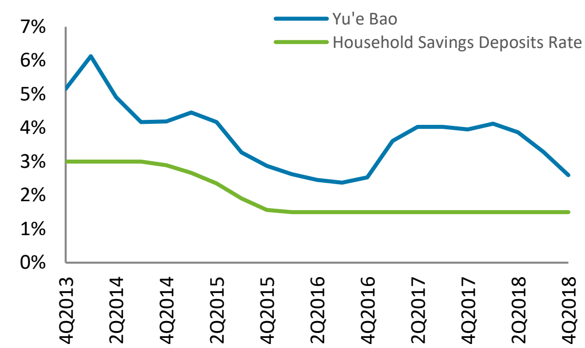
Quarterly average, percent



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

Supplemental 4: Return on Savings

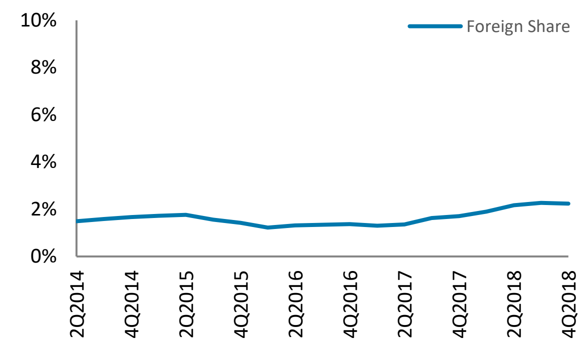
Quarterly average, percent



Source: The People's Bank of China.

Supplemental 5: Foreign Held Bonds

Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

POLICY ANALYSIS

The big policy emphases in 2018 were deleveraging and talk of increasing financial markets' openness to foreign participation, along with improving access to finance for the private sector. The most wrenching period of China's deleveraging campaign is probably in the past, but the consequences of years of rapid credit growth still loom over the economy. Slowing credit growth was an essential step, with credit growth close to nominal GDP growth in 2018.

Maintaining a credit cleanup in 2019 will be difficult. Chinese financial institutions extended a record RMB 4.64 trillion ($690 billion) in new credit in January alone. Managing credit growth clearly remains a key tool to stabilize the economy, along with aggressive fiscal policy support. In March, the National People's Congress work report set credit and monetary growth targets in line with nominal GDP growth. That may be wishful thinking (it is likely to be much higher), but it does at least show *intent* to avoid repeating the mistakes of the last round of policy stimulus in late 2015 and 2016.

The key area to watch this year as an indicator of Beijing's stance on financial risk is the regulatory structure, which successfully limited informal financing growth in 2018. A new institutional structure implemented in May 2018, including asset management product rules, will remain in place, even if monetary easing in an attempt to stabilize growth continues.

In terms of access to China's financial markets, both Premier Li Keqiang and PBOC Governor Yi Gang made commitments to additional opening in early 2019. At the annual China Development Forum in March, Li pledged that limits on foreign brokerage and insurance companies would be lifted, and thresholds for foreign participation in credit ratings, nonbank payments, and bank card clearing services would be reduced. Yi Gang argued for more rapid development of financial hedging instruments to facilitate greater foreign inflows into China's bond market. These signals are consistent with promises dating back to at least 2017, if not sooner, but progress has been limited for now.

One of the most significant financial reforms under consideration concerns bank funding costs, to reduce the regulatory arbitrage opportunities that gave rise to shadow banking and other financial risks. By allowing money market rates (where shadow banking products are priced) and deposit rates to converge, China would move closer to a developed market system of managing rates. So far, however, even though money market rates have fallen, deposit rates have not risen. Ultimately, the goal would be lending rates determined by market forces rather than policy decisions by the State Council, but this is likely to take time.

Finally, Beijing has continued efforts to drive additional credit to the more dynamic private sector, with the banking regulator urging banks to increase lending to smaller enterprises by 30% in 2019. This is a state-directed solution in lieu of a functional financial system. Some fundamental issues limiting private sector lending include collateral shortages and the lack of sufficient net interest margins in private lending to compensate for the additional risks; interest rate cuts focused on reducing bank funding costs would assist this process.