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 the 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 for 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 in 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.

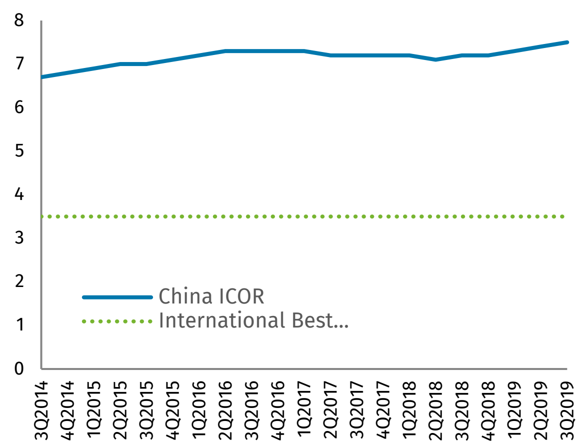
- Foreign investors' participation in China's financial markets has increased, and Beijing is encouraging foreign portfolio inflows in particular, with the expansion of programs such as the Bond Connect and Hong Kong–Shanghai Stock Connect starting in 2015. In 2018, foreign investors were key marginal investors in China's government bond market and exercised significant influence over China's domestic interest rates. In April 2019, Chinese securities were added to the Bloomberg Barclays Global Aggregate Bond Index, a major benchmark for global bond investors, for the first time.

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: International Monetary Fund, National Bureau of Statistics, Rhodium Group.

- Our assessment is neutral this quarter, with indicators moving in both directions. Shadow banking activity continued contracting, a positive in light of the poor regulation of the segment, but a negative for the outlook for private sector credit access. Overall, the financial system is still becoming less efficient.

- Credit growth is slowing, regulatory controls on shadow banking channels remain in place, and direct financing via the bond and equity markets is improving slightly.

- Rising credit stress points to more realistic pricing of financial risks. Banks have defaulted and been restructured, and state-owned enterprises (SOEs) along with local government financing vehicles have defaulted on both onshore and offshore bonds.

This Quarter's Numbers

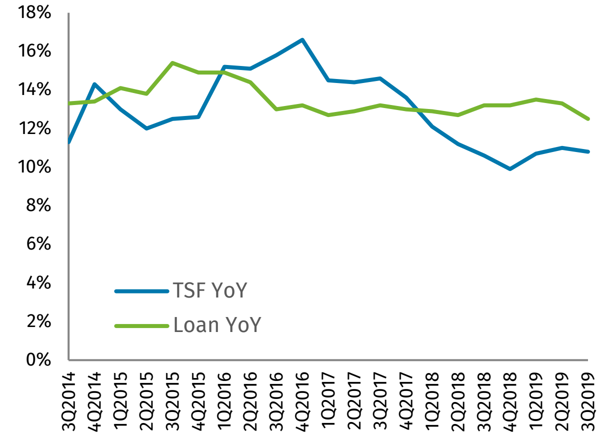
Despite efforts to improve market pricing of capital and to introduce new credit risk discipline into China's financial system, financial efficiency continued to deteriorate. Our **Quarterly Incremental Capital Output Ratio** (QuICOR) rose to 7.46 in 3Q2019 from 7.41 in the previous quarter and 7.21 at the end of 2018, which suggests that capital expenditures generated less economic growth. Reluctance to allow politically important, indebted firms and localities to fail means they continue to receive new credit, reducing financial efficiency.

Overall **Growth in Credit** slowed in the second half of 2019 in tandem with the broader economy. Two factors were responsible: the crackdown on shadow banking and the unintended market reaction to the default of Baoshang Bank in late May, which made it difficult for many banks to extend credit. Bank asset growth slowed to 8.2% in September from a recent peak of 9.0% in May, while loan growth slowed to 12.5% from 13.3% in the second quarter.

Falling money market interest rates helped make corporate bond issuance more attractive this quarter, thereby increasing direct financing to 19.2% of total financing in 3Q2019 (**Direct Financing Ratio**). Lower rates also effectively compressed the gap between interbank funding costs for deposit takers like banks and nonbank financial institutions to only 0.08 percentage points (**Interbank Lending Rates**). While this small spread indicates that riskier nonbank institutions are not under pressure from higher funding costs, regulatory tightening measures, including new restrictions on wealth management products (WMPs), have continued to squeeze shadow financial institutions.

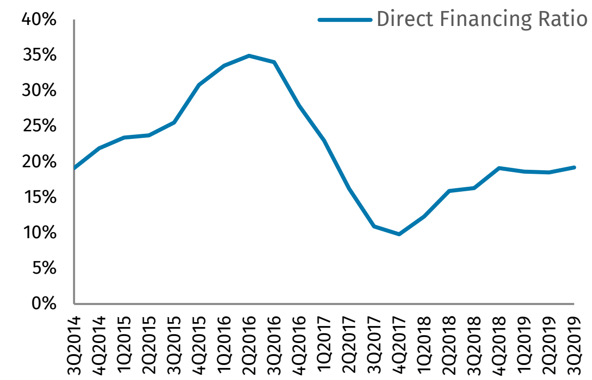
One of the most closely watched indicators of reform is the growth of foreign participation in China's financial markets, particularly within its bond market – a proxy of Beijing's tolerance for greater market determination of domestic interest rates. The proportion of **Foreign Held Bonds** in China's bond market increased only slightly, to 2.2% in 3Q2019 from 2.1% in the previous quarter. In gross terms, foreign participation has increased more sharply, with around $215 billion in new inflows into China's bond market over the past two years, according to State Administration of Foreign Exchange data. In addition, foreign ownership of China's government bonds and policy bank bonds has increased in recent years, consistent with the inclusion of China's securities in global indices.

Supplemental 1: Growth in Credit
Percent



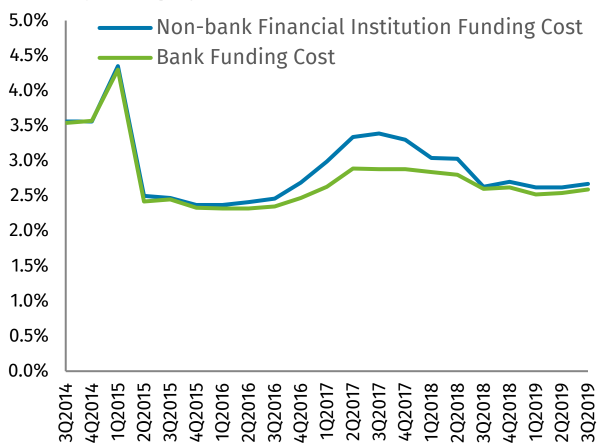
Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio
4qma, percent



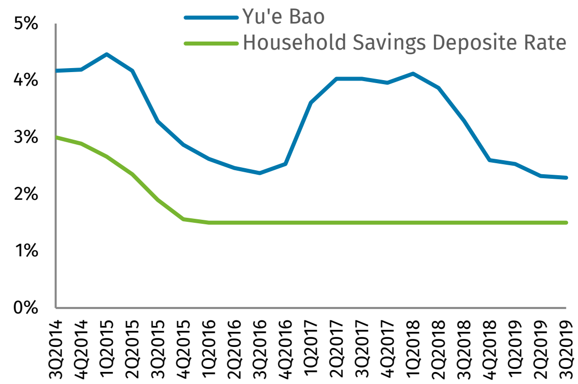
Source: People's Bank of China, China Securities Regulatory Commission.

Supplemental 3: Interbank Lending Rates
Quarterly average, percent



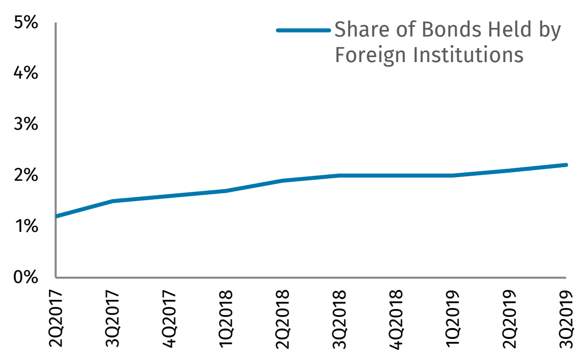
Source: National Interbank Funding Center, China Central Depository & Clearing Co.

Supplemental 4: Return on Savings
Quarterly average, percent



Source: People's Bank of China.

Supplemental 5: Foreign Held Bonds
Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

Policy Analysis

Policy efforts this quarter focused on increasing the market influence on bank lending rates. In August 2019, the People's Bank of China (PBOC) introduced reforms tying banks' lending rates (via the loan prime rate, or LPR) to their funding costs (see **Fall 2019 Edition**). This reform theoretically allows market-driven rates to play a greater role in loan pricing by allowing banks to price new loans based on the LPR rather than the previous benchmark rates. In December, the PBOC went further by requiring banks to price *existing* loans based on the LPR as of the end of March 2020. The new requirement should help reduce overall funding costs for the real economy, but it also means banks will face more balance sheet pressure and limit lending growth as they become more discerning in extending credit to riskier borrowers.

At the same time, the lending rate has not yet fallen significantly in response to market pressures because it is tied to another administratively set policy rate, the medium-term lending facility (MLF) rate, which prices to banks' funding. While banks set the LPR, the central bank sets the MLF rate. Banks need the PBOC to lower their funding costs to reduce lending rates to borrowers. Meanwhile, deposit rate liberalization has not progressed at all, as the central bank still informally caps bank deposit rates at 1.5 times the benchmark. As a result, a significant proportion of banks' funding is still priced by policy rather than market forces.

Credit events are becoming more frequent, which is positive for reform, although they carry considerable risks. Over the past several months, China's financial system has seen a series of new defaults by state-owned enterprises (SOEs), local governments, and banks. In 2019, the most important of these defaults was Baoshang Bank's failure on May 24 (see **Fall 2019 Edition**). The effects of Baoshang's default are still being felt, as smaller banks are facing tighter funding conditions in the interbank market and have been unable to grow their balance sheets as quickly.

Recently, SOEs and local governments have defaulted on onshore and offshore bonds. The government of Tianjin was unable to provide sufficient support for one of its SOEs, Tewoo, which defaulted on a $1.5-billion U.S. dollar-denominated bond. (Notably, the severity of debt-to-local GDP conditions is now understood to be far worse than previously believed in Tianjin following a recent 29% downward restatement of its 2018 economic output.) In addition, a local government financing vehicle (LGFV) in Hohhot, Inner Mongolia, defaulted on a domestic bond for the first time, while a Qinghai LGFV defaulted on an offshore bond earlier in 2019. These are all watershed credit events within China's financial system; while potentially dangerous for the overall economy, they are critical to improved market pricing of credit risks.

Steps toward financial sector liberalization and greater foreign ownership of financial companies will face a critical stage in early 2020. So far, China's leaders continue to offer additional opening to foreign participation. Both Premier Li Keqiang and PBOC Governor Yi Gang have committed to lifting foreign equity caps in the brokerage and insurance industry with concrete timelines for these opening steps in 2020 (see **Cross-Border Investment**). Foreign firms are allowed to fully own subsidiaries that offer life insurance and engage in futures trading at the start of the year. April 1 will mark the start date for foreign firms to apply for licenses for fully owned asset management firms. The Phase 1 U.S.-China trade deal signed on January 15 reiterated Beijing's financial opening commitments. The promises are not new, and even if fulfilled, foreign firms still may face obstacles to operating freely within China's financial markets. Lifting equity caps and actually facilitating foreign participation in China's financial markets are essential preconditions for improving overall efficiency.