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

- Our financial reform assessment is neutral this quarter: financial inputs generated less economic growth, indicating the financial system was less efficient.
- Regulators are squeezing high-risk behavior out of the market by keeping up shadow banking controls and reducing the gap in funding costs for banks and riskier nonbank financial institutions.
- New credit risk is materializing, which is positive for the direction of financial reform yet highlights fragility within China's system and the difficulty policymakers will face in rolling back guarantees too quickly.

This Quarter's Numbers

China's growth remains weighed down by a financial system unable to price capital and risk efficiently. Our **Quarterly Incremental Capital Output Ratio** (QuICOR) indicator rose to 7.36 in 4Q2019 from 7.24 in the third quarter, another record. This shows that investment in China produces far less growth than in other economies. This results from reliance on state-owned enterprises (SOEs) as the backbone of the economy—firms neither created nor managed to prioritize efficiency. Most of the new credit SOEs receive merely repays interest on old debts. This was the last pre-COVID quarter: return on investment will worsen going forward.

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

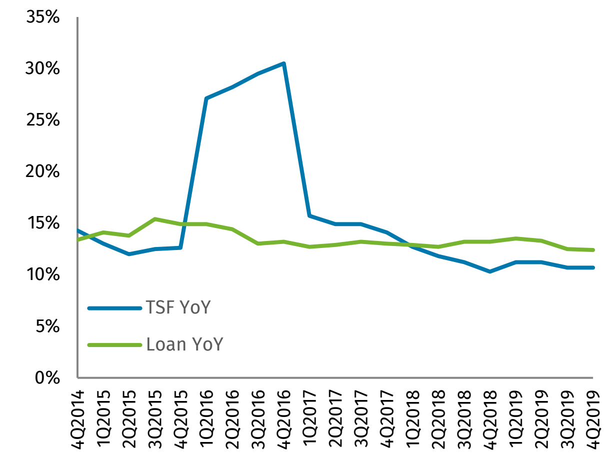
Source: International Monetary Fund, National Bureau of Statistics, Rhodium Group.

Growth in Credit remained stable in 4Q2019. Shadow banking continued contracting within China's credit data due to intensified regulation and changing risk perceptions following the failure of Baoshang Bank earlier in 2019. Credit growth has picked up so far in 2020 as borrowing rates were lowered in response to COVID-19. This is temporary: financial planners still think tighter credit policy is necessary for the long term to move beyond over-reliance on debt-fueled growth.

A significant reform indication is convergence between less regulated money market rates and more strictly policed bank deposit rates. Beijing has not liberalized deposit rates yet but has guided money market rates lower, effectively squeezing high-risk behavior out of the market. The gap between interbank funding costs for deposit-takers like banks and nonbank financial institutions was just 0.14 percentage points in 4Q2019 (see **Interbank Lending Rates**), leaving little room for arbitrage. In addition, lower Yu'e Bao deposit yields (under 2% in April 2020, down from an average 2.31% in 4Q2019) reduce opportunities for nonbank institutions to attract funding, as many banks are offering rates around 2.25% (see **Return on Savings**).

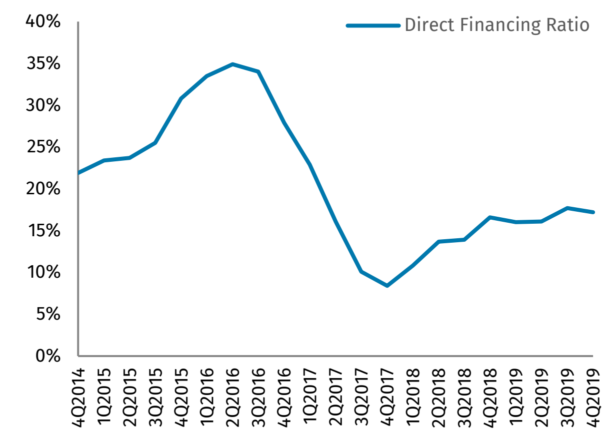
Foreign institutional investors still view China as a risky bet given capital controls and the potential for regulatory change in the event of financial stress. In gross terms, foreign ownership of China's government bonds and policy bank bonds has increased in recent years, as global indices have added China's securities into their weightings. However, the overall proportion of foreign ownership of China's bond market remains unchanged at 2.2% in 4Q2019, a low level for a financial system that aspires to be integrated into the global economy (see **Foreign Held Bonds**).

Supplemental 1: Growth in Credit
Percent



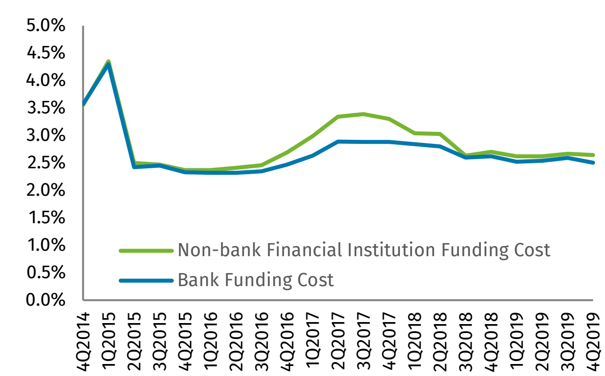
Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio
4qma, percent



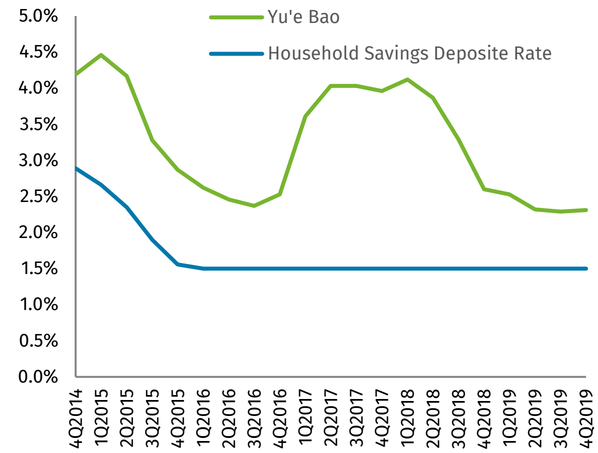
Source: People's Bank of China, China Securities Regulatory Commission.

Supplemental 3: Interbank Lending Rates
Quarterly average, percent



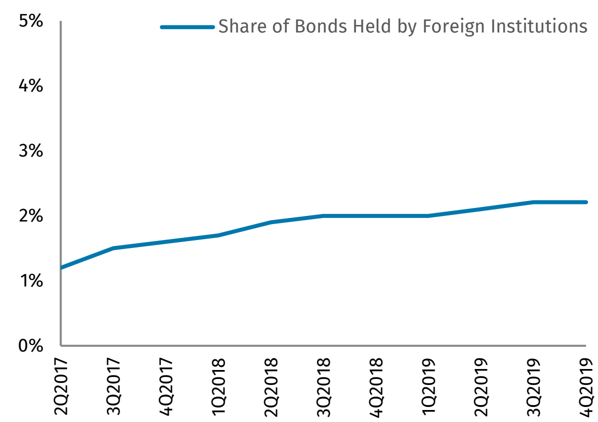
Source: National Interbank Funding Center, China Central Depository & Clearing Co.

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

Emergency efforts to stabilize the economy in the face of the COVID-19 pandemic have dominated the policy discussion this period. Short-term countercyclical steps do not necessarily indicate long-term directions. The challenge is to distinguish what is permanent from what will be fleeting, which is hard given that no one knows when the coronavirus crisis and its associated economic fallout will end.

Lending rates are becoming more closely tied to market rates, but deposit rate liberalization is slowing. Late in 2019, the People's Bank of China (PBOC) announced that banks would be required to price existing loans based on the new loan prime rate (LPR) as of the end of March 2020. This means lending rates will fall, as well as bank profits (so-called net interest margins). The central bank used its tools to lower bank funding rates (in China's money markets) to make that possible, so that they can pass lower costs on to borrowers without hurting bank profits too much. This new system links money market rates and corporate borrowing rates in the real economy, providing a more credible guide of true demand and supply of credit (though it ultimately depends upon rates set by the PBOC). The deposit rates paid to regular bank depositors on the other hand are unlikely to be liberalized soon.

Credit risk is increasing, as more banks face liquidity pressure given low rate incentives to work with them, and corporate bonds are defaulting in much larger numbers. Four banks were officially restructured in 2019, most notably Baoshang Bank in Inner Mongolia in May. The PBOC even used a new financial vehicle (Chengfang Huida Enterprise Management Co., or "Huida") to recapitalize one of them (the Bank of Jinzhou). In early April 2020, the Bank of Gansu in northwest China faced a sudden bank run, forcing the PBOC to announce yet another restructuring plan.

Corporate bonds are defaulting in greater numbers. Default levels are likely to exceed 3% of total maturing issues in 2020 (approaching more developed bond market levels). These are positive signs for the direction of financial reform, as they are necessary for market pricing, but they also highlight fragility within China's system and the difficulty policymakers will face in rolling back guarantees too quickly.

Opening to foreign participation continues, with a slight nudge from the U.S.-China Phase One trade deal (at least for U.S. firms). Chinese officials advanced the timeline for piecemeal financial sector liberalization with the Phase One agreement, removing some equity limits and more restrictive licensing and operating requirements for asset management (mutual fund) firms as of April 1. Several firms have applied to the China Securities Regulatory Commission to take wholly owned stakes in onshore asset management businesses, including Blackrock, Neuberger Berman, and JPMorgan.

The Phase One deal also secured foreign participation (for U.S. firms) in provincial licenses to purchase distressed debt, but this falls far short of nationwide market access. China also authorized the creation of a new national-level asset management company, Galaxy Asset Management Company, in a sign of liberalization and diversification of the distressed debt industry away from the existing four national-level players (Huarong, Cinda, Great Wall, Orient). This may create more opportunities for foreign investors in the future, but so far the steps taken are incremental and unlikely to generate much new inbound investment.