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# China Financial Policy Focus (Q3, 2017)

**China Economics Network**

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**SUMMARY**

**President Xi sets the agenda for China's financial services at the five yearly meeting of the National Financial Work Conference. Tackling financial risk, maintaining a path to liberalisation and ensuring finance serves the real economy are key themes. The central bank and banking regulator lead efforts to de-risk the interbank markets, and with success. Governor Zhou leads the charge for bolder reform and liberalisation in a sweeping interview in *Caijing* magazine ahead of the 19th National Congress and ahead of his likely retirement later this year.**

## Xi sets the Agenda

**In July, President Xi chaired the five-yearly National Finance Work Conference, setting out key reform priorities for China's financial services.** This year's meeting comes on the back of an exceptional Politburo meeting called by President Xi in May which called for greater efforts to safeguard financial security, tackle fraud and corruption, and mitigate risks in the system.

**Grabbing the headlines, the Working Conference agreed to establish a new Financial Stability and Reform Committee**. More than a coordinating committee over the regulators, as well as parts of the NDRC and MOF, the Committee will also have power to drive policy changes. It will be chaired at State Council level with its Secretariat within the People's Bank of China (PBOC), reinforcing the central bank's primacy over the other regulators. At this year's annual meetings Governor Zhou Xiaochuan revealed that the Committee was firstly focused on consolidating asset management regulation, strengthening licence requirements on FinTech firms and clamping down on regulatory arbitrage in shadow markets.

**The Conference also committed to further reform and opening up of the financial sector.** Following the Conference the State Council issued a directive (No.39) on 16 August requiring the regulators and a number of government ministries including NDRC and MOFCOM to draft timetables and roadmaps for opening up sectors, with particular mention of banking, brokerages and insurance. The PBOC and SAFE were also tasked to ensure that foreign investors are able to freely remit their profits. Furthermore the directive also committed to more rigorous enforcement at local levels, and even encouraged foreign capital to participate in SOE reform.

**Ensuring that "finance serves the real economy" was a key third theme of the Conference.** It goes hand in hand with tackling enormous and risky growth in the interbank markets and has been a recurring theme over the last few months with senior regulators.

## Tackling interbank risks

**The People's Bank of China and China Banking Regulatory Authority (CBRC) have spearheaded the charge to tackle leverage and risks in the interbank market.** The CBRC has tasked all banks to produce an internal self-assessment of their exposures in the interbank market and produce roadmaps to reduce off balance sheet activity and reliance on interbank funding. The reports were originally due in June but deadline has been extended.

**Indications are that the regulatory action is starting to bite in the interbank market.** Since the beginning of the year medium-sized joint-stock banks have reduced interbank assets by 45%, with total interbank assets contracting 13.8% since August of 2016. Year-on-year M2 growth rate continued to slow in Q2, and for the first time fell below 9% in August (8.9%). The interbank lending rate (3M SHIBOR) eased from a peak of 4.47% in Q2 to 4.34% in Q3, but this is still 150 bp higher than last year. The seven day deposit rate (DR007) which reflects the funding cost of deposit-taking financial institutions has also risen through the year with and with greater volatility in Q3 (Figure 1).

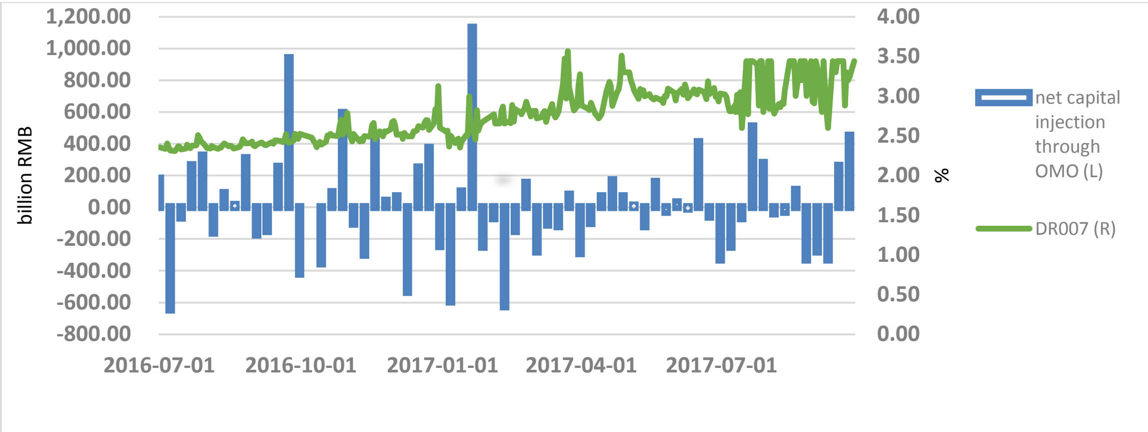


Figure 1: Net capital injection and money market rate, Source: WIND

**The PBOC has also tightened the screws on Negotiable Certificates of Deposit (NCDs) which have grown rapidly in recent years in the interbank market.** From a standing start five years ago, these short-term, uncollateralized, funding instruments now total RMB8.3tn, almost 30% of inter-financial liabilities. With increased PBOC attention including inclusion in its macro-prudential assessment toolkit, a ban on certain types of NCDs, and the prospect of having to hold collateral, NCD redemptions have spiked with almost a third of the total redeemed in September alone.

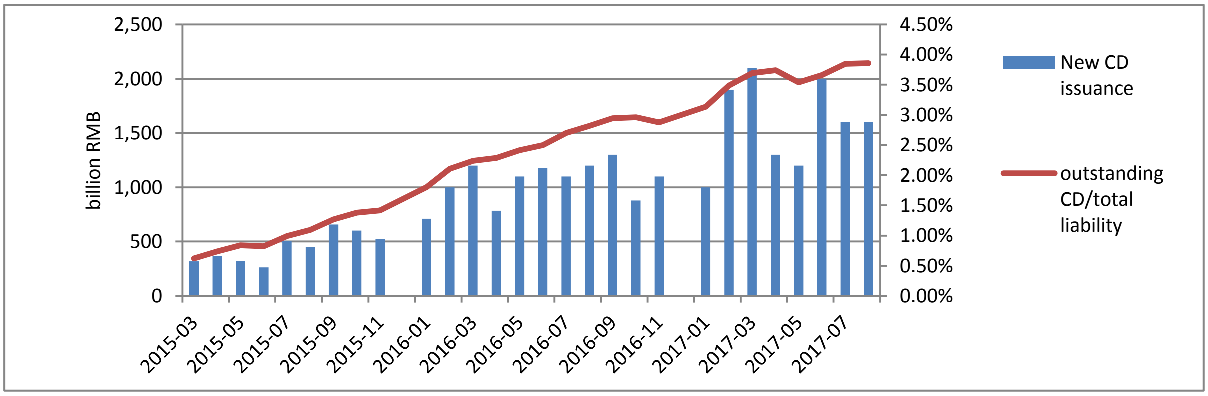


Figure 2: Growth in Negotiable Certificates of Deposits, Source: WIND

**Financial innovation has also been targeted, with virtual currencies in the firing line.** Financial innovation has barely figured in the authorities' communications in the last few months. The China Securities Regulatory Commission Vice Chair Jiang Yang recently vowed comprehensive and strict regulation, in particular to correct "fake innovation" that detracts from serving the real economy. In early September, a seven ministry announcement led by the PBOC declared initial coin offerings (ICOs; a product to allow fund raising through virtual money) "an illegal public finance used for securities issuance and money laundering". In the following week, the regulators announced plans shut down all crypto currency exchanges in Beijing and Shanghai, with the country's three largest crypto-currency exchanges suspending operations.

**The stock of Total Social Financing (China's measure of official credit) has nonetheless continued to grow, increasing 18% year-on-year (Figure 3).** Whilst the regulators are tightening liquidity, it's clear that this has not yet impacted credit creation which has hovered around 13% over the last year.

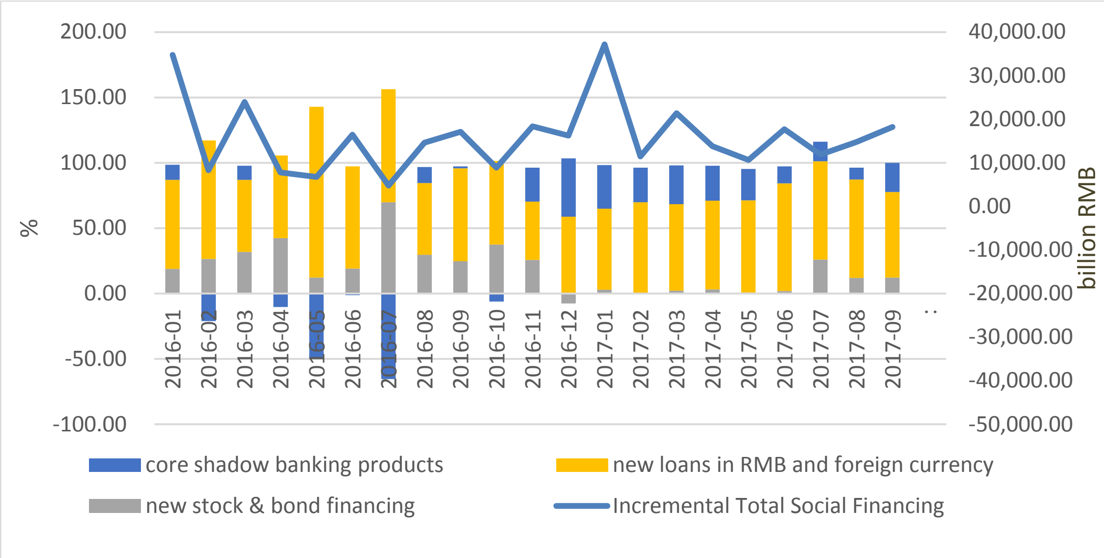


**Figure 3: Credit Growth since January 2016, Source: WIND**

**At the end of September the PBOC also issued a targeted Reserve Ratio Requirement (RRR) cut to encourage bank lending to micro and small businesses.** The cut in the RRR will be implemented in early 2018 and will only benefit banks meeting minimum criteria including (amongst others) providing credit to micro business, student loans, consumer loans and guarantees for start ups. Even as regulators tackle excess leverage at a macro level the cut is designed to inject and target between RMB600-800bn of additional finance in the system. PBOC stressed following the announcement that this is not indicating a shift from prudent monetary policy, but instead to guide finance into priority areas and echoing the Working Conference, helping "finance to serve the real economy".

## Tighter capital account, stronger RMB

**The onshore RMB (CNY) has strengthened 2% against the USD this quarter, and 4.5% since the start of the year.** down since joining the SDR basket in October 2016. Appreciation has been driven by a combination of USD weakness and improved market sentiment on China. The authorities have also sought to tighten the screws on capital outflows with the NDRC releasing a new guidance in August restricting State Owned Enterprises from investing overseas in certain industries including real estate, hotels, entertainment, sports and casinos.

Earlier this year, the PBOC also changed its fixing formula for the CNY by expanding the basket of currencies the currency is pegged against in order to dampen the dollar link, and introduced a "counter-cyclical" factor to weaken the link between the CNY “fix” and the previous day’s close. As a result, RMB/USD exchange rate curve has more closely followed the RMB/currency basket (CFETS) trend (Figure 4). Foreign exchange reserves have risen for 8 consecutive months since February, and reached USD 3.185 trillion in September.

**Policy interventions by the PBOC have reversed some of the gains.** On September 8, the PBOC removed the 20% reserve requirement for onshore financial institutions when buying FX forwards for clients, first introduced in October 2015 to help reduce capital outflows. The bank has also scrapped the reserve requirement for offshore banks’ interbank renminbi deposits held onshore which had been introduced in July 2016 to deter offshore short-selling of renminbi. Plans by the US Federal Reserve to normalise its balance sheet over the coming year and the prospect of US rate rises will also likely soften or reverse the upward pressure RMB.

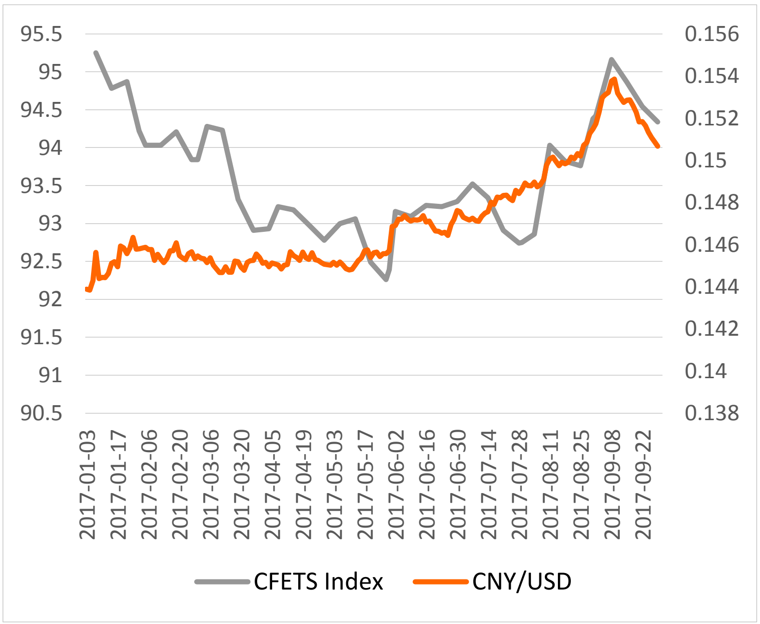

Figure 4: Onshore RMB exchange rate; Source: WIND

__**The run up to Congress**__

**Ahead of the Congress, and in his final months in charge, central bank Governor Zhou Xiaochuan has publicly argued the case for deeper and more ambitious liberalisation.** In a lengthy interview with *Caijing* newspaper, in a broadside at those obstructing reform, Zhou called for the government to seize the opportunities to further open the economy and ease the capital control. Zhou’s intervention comes on the back of a bold report released by the influential CF40 thinktank and backed by senior PBOC officials and Huang Yiping, member of PBOC monetary policy committee and deputy dean at the prestigious Peking University. The report calls for more ambitious liberalisation and an “adventurous leap” to liberalise the RMB exchange rate regime. However, with Governor Zhou expected to retire soon, China will lose a powerful driving force for reform and liberalisation. It remains unclear who will succeed him.