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China Economics Network

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SUMMARY

China's 19th Party Congress heralds Xi Jinping Thought, with a renewed focus on tackling financial risks and a shift in growth priorities to quality over quantity. Economic Work Conference targets financial risk as one of 'three battles' with regulators driving efforts to clean a sprawling and opaque asset management industry. PBOC further squeezes the money markets, with government yields hitting a three year high. Opening up remains on the cards with the long-awaited lifting of restrictions on foreign investment into the financial sector, and significant outcomes at the ninth UK-China Economic and Financial Dialogue.

Xi's Priorities

The 19th Party Congress heralds "Xi Jinping Thought on Socialist Economy with Chinese Characteristics for a New Era". The Congress itself was light on details but carried a significant reframing of the contradiction facing Chinese society. Whereas since 1981 the contradiction has been between "ever-growing material and cultural needs of the people and lagged-behind social production", the new contradiction is between unbalanced and inadequate development and the people's ever-growing needs for a better life. Put simply, growth will focus on quality over quantity. Xi's flagship Belt and Road Initiative was also formally written into the Party constitution.

The annual Economic Work Conference added flesh to the bones and re-emphasised the importance of "promoting progress while maintaining stability". The conference also identified three core battles: risk prevention, targeted poverty alleviation, and pollution prevention. In particular the Conference stated that the "bottom line" is to prevent systematic financial risk. At a December Politburo meeting President Xi added detail, emphasising the need to ensure the financial sector better served the real economy, ensure positive results in guarding against risk, and ensure overall leverage is under effective control. Some analysts sparked on the focus on "effective control" of leverage as subtle but important shift away from "deleveraging" which had been a key focus in the two previous Economic Work Conferences.

Tackling Risks

Heeding the President's words, the authorities have unleashed a flurry of activity to tackle financial risk including the first meeting of the new Financial Stability and Development Committee (FSDC). Chaired by Vice Premier Ma Kai the FSDC held its first meeting in November stating that is priorities will be to push through greater coordination of financial regulation, ensuring financial services serves the real economy, safeguarding national financial security, and protecting consumers. The Committee is a welcome development and should help to tackle regulatory arbitrage that remains rife in the Chinese financial system. The secretariat for the Committee will sit within the PBOC, and Vice Chairman from the different regulators will attend regular meetings of the Committee. There are rumours that the PBOC will appoint a new Vice Governor with responsibility for leading the Committee's work on a day to day basis.

Consolidating and tightening regulations in the asset management industry has been an immediate priority for the new Committee. The PBOC and three other regulators have issued new regulations that seek to unify classifications for asset management product (AMPs), set limitations on investment scope and qualified investors, prohibit selling products with guaranteed returns to investors, prohibit cash pooling, and set a debt limit on AMPs. The regulation, though not applicable till 30 June 2019, will likely increase pressure on medium and small sized banks that have been most heavily reliant on AMPs as a source of funding.

China Banking Regulatory Commission in early December also issued draft rules on commercial banks' liquidity management. The rules, which will be effective 1 March 2018, introduced three new indicators, namely the net stable funding ratio, the high-quality assets adequacy ratio and the liquidity matching ratio. The three indicators examine whether banks have stable funding and high-quality assets to cover obligations, as well as have a reasonable maturity match between their assets and liabilities.

Moreover, PBOC and CBRC together circulated a new regulation on the micro-lending field, prohibiting unlicensed institutes and individuals from conducting lending business. The regulations stipulate that lenders should not give loans to unqualified borrowers or mislead them in to over-borrowing. Any new approvals for online-lending and cross-region lending operations will also be put on hold.

<u>**Tighter markets**</u>

The PBOC continued to squeeze China's money markets, with interbank lending rates continuing to rise, and bond yields hitting a three year record. In particular, the PBOC raised the reverse repurchase agreements (repos) and medium-term lending facility (MLF) interest rate by 5bp following the 25bp rate hike by the US Federal Reserve in Dec. The PBOC also hiked the open market operations rate 5bp, the third rate hike this year (last two in January and March with 10bp hikes each). Reflecting tighter, and more nervous markets the yield of the benchmark 10-year China Government Bond (CGB) hit a three-year record high, nudging above 4 percent.

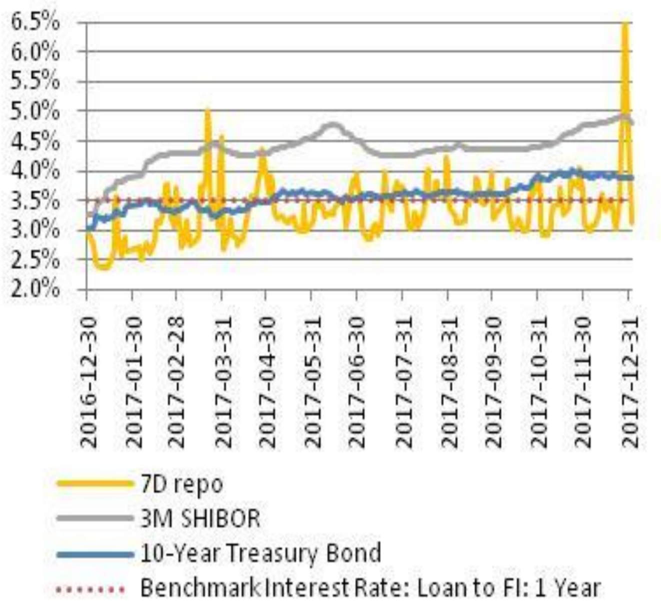

Figure 1: Market interest Rates; *Source: Wind*

At the same time the market expects the PBOC will keep benchmark policy rates unchanged through 2018. Inflation expectations are shifting however, with forecasts of higher inflation around 2.5%, though still below the government target of 3%. US Federal Reserve rate hikes will also increase pressure on China's benchmark policy rates.

Policy tightening has fed through to slower growth in China's M2 money supply with a record low annual increase of 8.8% in Oct, but deleveraging remains muted. Whilst traditional loan growth though has remained robust (accounting 76% of incremental Total Social Finance in November), interbank leverage has reduced. Two key risk signals, Wealth Management Products (WMPs) and interbank Certificate of Deposits (CDs), have substantially dropped-off in size as a result of the recent regulatory actions. Moody's estimate that broad shadow banking activity in China stopped growing during the six months between January and June 2017 (H1 2017). And, for the first time since 2012, nominal GDP grew faster than shadow banking assets during H1 2017, with shadow banking assets now accounting for 82.6% of GDP at 30 June 2017 versus a peak of 86.5% in 2016. "

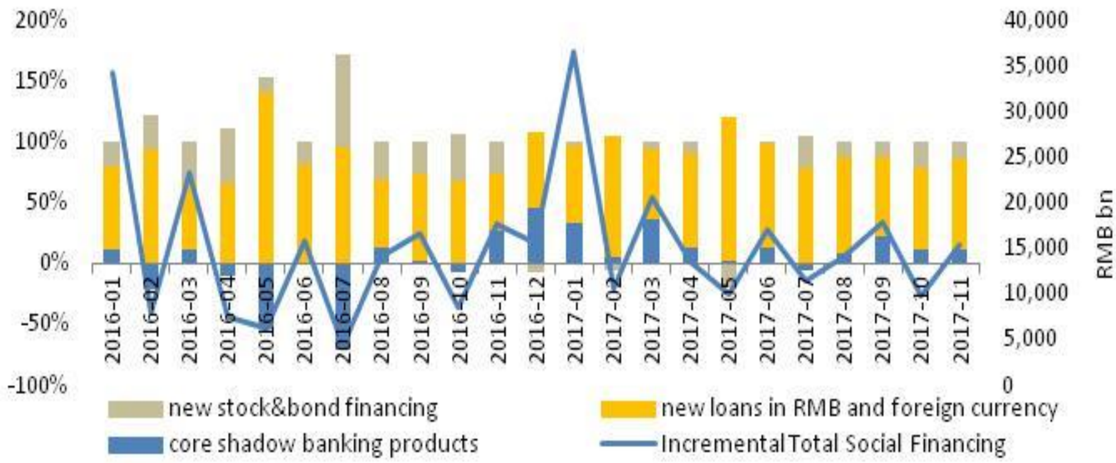

Figure 2: Total Social Financing and its components; *Source: Wind*

There has been no relaxation of measures implemented over the last year to stem outflows and tighten the capital account. Partly as a result, the Chinese Yuan exchange rate recorded 6.512 on the Dec 31st, ending a yearlong strengthening trend (7%+). FX reserves held by the People's Bank of China (PBoC), a key proxy for overall flows, rose for the 11th month in a row to USD3.1tn in Dec.

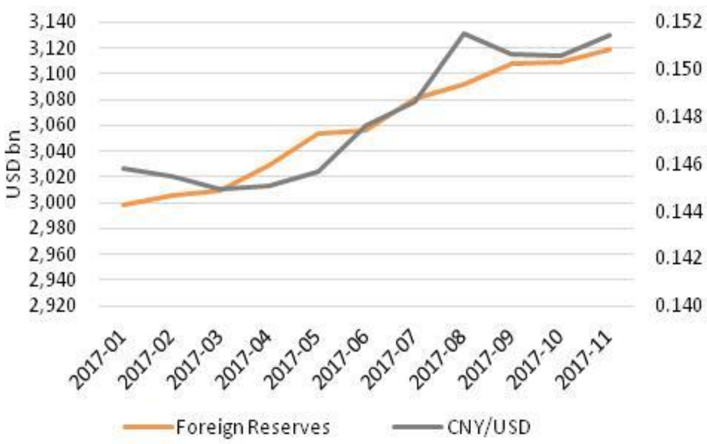

Figure 3: CNY/USD and foreign reserves; *Source: Wind*

The US tax reform has raised concerns within China's government ranks. In December, The US Senate approved a tax bill on permanent corporate tax cut (from 35% to 20%) and temporary individual tax cuts. Zhu Guangyao, Vice minister of MOF publicly stated that the spill over effects of the world's largest economy's tax policy should not be neglected. Major concerns include potential RMB deprecation and capital outflow, along with increased urgency on reform of China's local tax systems.

Opening Up

Gradual opening up of the financial sector remains on the government agenda, substantiated by an announcement to lift foreign ownership caps. In November, the Ministry of Finance announced that foreign firms will for the first time be permitted allowed to own a 51% stake in fund, brokerages and future companies with the cap removed altogether after three years. Individual foreign investment in Chinese banks will also be lifted above 20% with no cap on total foreign ownership. Foreign life insurers will be allowed majority ownership in three years time, with the cap removed after a further two. Further details on implementation the banking sector have been released and we expect announcements relating to the securities sector in the near future.

The announcement opens up the largest and fastest growing sectors of China's financial market. Investment in Chinese banks however will be expensive given their lofty valuations. Opportunities are likely greater for firms seeking to acquire a full suite of funds, futures and securities business, though some foreign firms may wait for the bigger prize of full ownership. Across the board, even with greater access, domestic giants have managed to build dominant market positions and will be hard displace.

The PBOC is also close to concluding the regulators' "roadmaps" for reform and opening up as mandated by the State Council early last year. Whilst we don't expect these roadmaps to be made public, they will shape the trajectory for further opening up over the coming year.

UK-China Ninth Economic and Financial Dialogue (EFD)

The ninth UK-China EFD held in December delivered a suite of financial services outcomes, testament to the ongoing gradual opening up of China's markets. In particular HSBC secured a new licence to underwrite panda bond issuance in the China markets, both sides launched feasibility studies into UK-China bond connect and mutual recognition of funds, FinTech firm R5 established a partnership with Shanghai Clearing House to provide foreign exchange services, and a number of new asset managers established WFOEs in Shanghai and registered to undertake private fund management business.

The Belt and Road Initiative was a key element of discussions with a number of concrete initiatives to deepen bilateral cooperation. Both sides will take forward collaboration to identify pilot projects for UK-China cooperation, undertake joint research on joint finance mechanisms to crowd in private capital, and the Chancellor announced a new Belt and Road Finance and Professional Services Envoy, former HSBC Chairman Douglas Flint, to drive forward deeper UK-China financial collaboration on this vast initiative. Prime Minister May's visit to China in 2018 will provide a unique opportunity to build on the outcomes from this year's EFD.