



China Financial Policy Focus (Q2, 2018)

SUMMARY

The stock market is firmly in bear territory (valuations are at record lows) and bond yields have been increasing. Rising trade tensions between the US and China have only added further fuel to the fire, causing the stock market to fall more than 20% against its peak in January and leading the currency to depreciate substantially against the dollar. This is not though the Chinese stock market ‘crisis’ of 2015. The PBoC is taking targeted action to increase liquidity and ease stress. To shore up fundamentals, a new regulatory architecture is in place and the leadership is tackling domestic financial debt. Amid this backdrop the government seems to remain committed to further opening up.

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International: trade tensions versus opening-up

US-China trade war heats up

Chinese financial markets have wobbled since it became clear that tit-for-tat tariffs would be imposed at the beginning of the quarter. Following weeks of strained negotiations between Washington and Beijing tensions reignited in June with the commensurate effect on markets.

Stock market: Domestic stocks have been volatile in the second quarter. The Shanghai index has had several days of major losses since the US announced plans to introduce tariffs on Chinese goods on 22 March. Shares tumbled again on 19 June, with the benchmark stock index closing below 3000 points due to rising trade tensions over the long weekend. Yi Gang, China’s central bank Governor, called for investors to stay “calm and rational”, adding that the central bank has the tools available to maintain liquidity. The Shanghai Composite Index has declined more than 20% since its January 2018 peak. By 28 June the index was below 2800 points.

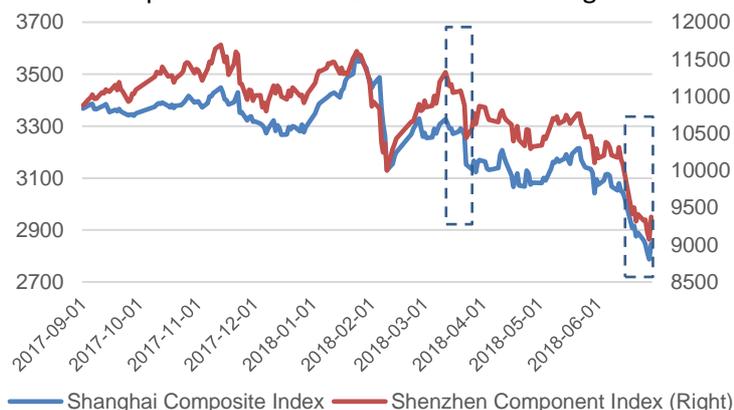


Figure 1. Chinese share indices falling Source: WIND

Forex market: It hasn’t only been the stock market that has been hit hard. The Chinese currency has been depreciating against the dollar, hitting a one-year low in early July. A deepening trade war with the US will pile additional pressure on the RMB, with further depreciation a risk. Despite some commentary in the press, it does not seem that the PBoC has directly intervened in currency markets to shore up the RMB.

There is some circumstantial evidence, however, that the big state-owned banks have been buying RMB assets which has the same effect. Nevertheless, the PBoC is seeking to set expectations, with several senior figures making statements to the effect that the currency will stabilise.

Reform and opening-up continues

Despite escalating trade tensions China has remained committed to continued opening up, with several key announcements this quarter.

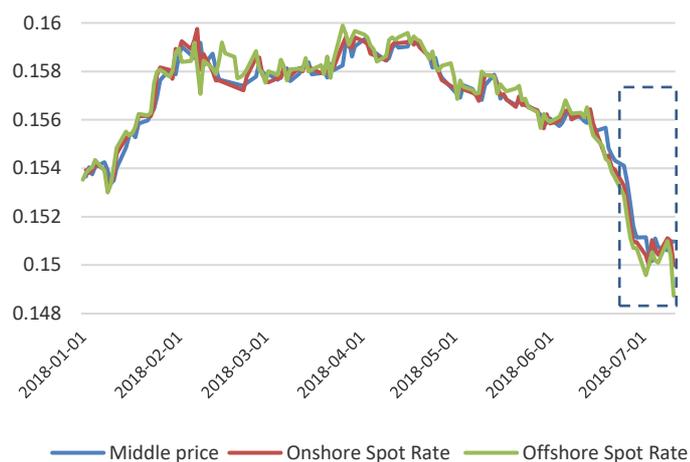


Figure 2. USD/CNY (CNH) exchange rate *Source: WIND*

China allows majority control of securities firms and eases restrictions on qualified foreign investors

China revealed new regulations that allow majority ownership of local securities firms for the first time. The CSRC lifted the cap from the previous 49%, permitting a controlling share of 51%. This makes an expensive two percent increase for firms already in the market but creates new opportunities for companies previously put off by lack of majority ownership. This is an important development within the context of the continuing trade war.

The foreign exchange regulator SAFE revised rules in June to ease restrictions on qualified foreign investors in Chinese stocks and bonds. The new rules scrap a 20% monthly cap on moving assets out of the mainland for QFII participants. A requirement for a three-month lock-up period for investment principal has also been removed. Investors in the QFII and RQFII programmes can now send money out of China based on investment need and, importantly, will also be allowed to conduct foreign exchange hedging in China to offset risk from forex movements. The new rules took effect immediately and make it easier for foreign institutional investors to move money out of the country.

Securities regulator releases CDR guidelines but tech giants are less enthusiastic

The CSRC published highly anticipated guidelines for its China Depositary Receipt (CDR) pilot programme. Xiaomi initially planned to offer CDRs at the same time as its Hong Kong initial public offering, which would have made it the first company to issue the receipts under a pilot programme but announced that it had decided to postpone. This comes shortly after the Shanghai and Shenzhen stock exchanges announced detailed rules specifying the standards companies must meet to offer CDRs. These include limits on dual-class share structures, which are favoured by tech founders and family companies as a way to retain control. In a further move against dual-class share structures, the Shanghai and Shenzhen stock exchanges announced they would exclude dual-class shares from the Hong Kong Stock Connect – Xiaomi is currently the only company affected by the news. The Mainland bourses have since given high level indications that they will work towards including these structures in the future. Overall, it's been a bumpy quarter in the world of Mainland equity.

MSCI includes more than 200 of China's biggest public listed companies

MSCI added 226 A-share stocks listed in Shanghai and Shenzhen to its benchmark Emerging Markets Index on 1 June. The inclusion of Chinese stocks was the culmination of a years-long campaign by Beijing to broaden foreign participation in the nation's stock markets. Under a phased inclusion plan, Chinese shares currently make up 0.39% of the index. Following MSCI's quarterly index review on 3 September, the aggregate weight of A-shares will reach 0.78% in the index.

The CSRC wants greater ambition, with Fang Xinghai, Deputy Chairman of the CSRC, calling for a much larger proportion of Chinese shares at the Lujiazui Forum in Shanghai. To make that a reality, the CSRC is working on new systems and policy tools, including a stock pricing mechanism, trading suspension rules and making stock index futures trading available to foreign investors.

Domestic: one hand giveth and the other taketh away

Regulators remain committed to the campaign to reduce leverage in the economy, despite weakness in the bond market. The PBoC continues to prioritise managing over-heated financial activities and the shadow banking sector, while continuing its campaign of deleveraging debt owned by SOEs (particularly zombie firms), and local government (including Local Government Financing Vehicles). Despite best efforts the regulators face strong resistance. Data show that China's economic growth cooled across the board in May as expansion in investment, industrial output and consumption all moderated, undershooting expectations. There are already signs of targeted monetary easing and it is widely believed that the government is unlikely to tighten monetary policy given liquidity has already been constrained due to the crack down on lenders' off-balance-sheet activities.

Monetary Policy: from "reasonable and stable" to "reasonable and ample"

PBoC introduces two targeted Reserve Requirement Ratio (RRR) cuts in Q2

In April, banks were required to use newly freed-up liquidity to pay back loans obtained from the PBoC via the medium-term lending facility. The PBoC said it will lower RRR by 1% for banks whose current RRRs were either 15% or 17%, releasing a net total of RMB 400bn. In June, the PBoC announced it would cut the amount of cash set aside as reserves by 50 basis points from 5 July, releasing a further RMB 700bn of funding. Around RMB 500bn will be used by the five state-owned banks and the 12 national joint-stock commercial lenders to support debt-for-equity swaps. Another RMB 200bn released to small and midsize lenders is intended for loans to small businesses.

PBoC accepts lower-grade collateral for lending facility

At the start of June, the central bank attempted to boost financing to smaller firms by broadening the kind of collateral it accepts. The PBoC added AA-grade-and-above small-and-micro enterprise bonds, green bonds and agriculture-related financial bonds; plus AA+ and AA corporate credit bonds; and high-quality small and micro-enterprise loans and green loans to its list of eligible collateral. The government is attempting to broaden the appeal of lower credit bonds.

PBoC holds rates steady following Fed tightening

The PBoC kept its policy rates on 7-day reverse repo agreements and other open market operation instruments unchanged on 14 June, even though the US Federal Reserve Bank raised its benchmark rate the day before. The market expected the PBoC to follow the Fed and introduce a modest interest

rate increase. This would have kept the spread between Chinese and US yields stable, reducing the risk of potential capital outflows due to relatively more attractive dollar assets. Outflows which could further pressure the RMB. The decision to forego a rate hike shows that domestic factors have overtaken the external situation in determining the Chinese central bank's policy stance.

Regulation: from deleveraging to structural deleveraging

On 2 April, the new Central Financial and Economic Affairs Commission¹ held its first meeting. In an otherwise uneventful first meeting, the main output was a proposed campaign of "structural deleveraging", suggesting that future tightening measures may be more targeted rather than economy-wide.

Asset and wealth management revolution

In late April, China published the final version of unified regulations, approved by president Xi Jinping, for the country's \$15 trillion asset management industry. Regulators are also drafting detailed rules for banks' wealth management businesses, designed to supplement the asset management regulations. The new rules are likely to impose more stringent requirements on the investment scope of banks' wealth management products, limiting their exposure to non-standard investments. With markets being firmly in bear territory recently, regulators may be tempted to delay the introduction of these new rules rather than risk further upsetting fragile markets.

Deleveraging must consider what the market can bear

Guo Shuqing, Chairman of the CBIRC, pointed out in his keynote speech at the 10th Lujiazui Forum that deleveraging and the mitigation of financial risk are a long-term battle, and that measures will be taken gradually, taking into account market factors. Guo also fired a strongly-worded warning shot to financial conglomerates, suggesting there would be a zero-tolerance approach to such companies – seemingly a thinly-veiled threat to conglomerates such as Anbang.

Market overview

• **Crack down on off-balance sheet financing**

Total social financing includes off-balance-sheet financing and can provide hints about activity in China's shadow banking sector (see Figure 3). China's regulators have been clamping down on off-balance-sheet lending to rein in financial risks, a key government priority. The sharp contraction in off-balance-sheet financing has already challenged the real economy's ability to access finance. Cutting off shadow banking channels limits the ability of local government financing vehicles, the main source of non-budget funding for local authorities, to raise money.

While, private enterprises, which find it harder to obtain financing than their state-owned peers, are hit hardest.

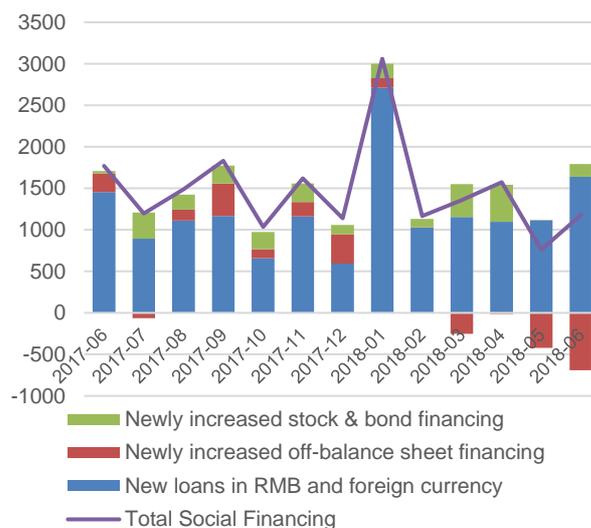


Figure 3. Newly increased Total Social Financing (bn RMB)

¹ Formerly known as the Central Leading Group for Financial and Economic Affairs

- **Bond default**

As of early July a total of 15 companies have defaulted on 27 bonds in the credit bond market, with ten companies defaulting for the first-time. The defaults totalled nearly RMB 27bn. Private businesses are the main culprits, although it is noteworthy that provincial government-backed Sichuan Coal Industry Group also defaulted. This is, though, the only state-backed entity to default this year. Defaulting companies represented a cross-section of industries, including traditional manufacturing, environmental protection and port management.

- **Banks establish wealth management subsidiaries**

As of June, ten of 27 banks licensed to sell mutual funds and trust products have announced they would establish wealth management subsidiaries. Regulators will create criteria for banks to set up wholly owned Wealth Management Product (WMP) units. The goal is to get banks to spin off these arms to separate their WMP business from their loan and credit businesses. That could help further prevent credit from flowing into the shadow banking industry, where risks are larger and more opaque.