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China Economics Network

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SUMMARY

China's Politburo states the country is facing "new problems and new changes", including "obvious changes in the external environment", and the policy balance shifts from deleveraging to stable growth. China's stock and exchange markets have sunk dramatically triggering intervention by the government. Growing concerns for China's private sector as the government pulls out the stops to support China's SMEs. Markets continue to creak open with the UK taking top place as the global centre for RMB FX trading.

Tinker, tailor, fiscal, stable

The deleveraging campaign has been a major government focus and is one of President Xi's "three major battles". However, concerns are growing that slower growth may force a retreat with the world "stability" writ large and repeatedly throughout the Politburo's October meeting report.

In particular, and uncharacteristically, the PBoC and Ministry of Finance indulged in a public spat on the way forward with the PBoC Research Bureau publicly criticising fiscal policy for failing to play a "countercyclical role", noting that China's budget deficit target this year of 2.6% of GDP is contractionary compared with last year's 3%.

The State Council has seemingly come down on the side of a more active fiscal policy, with a focus on tax reduction and pushing forward infrastructure spending via local government-issued bonds. The Ministry of Finance set this year's quota for special bond issuance 69% higher than last year.

Growing trade tensions have served to sharpen the policy choices facing the Chinese government. The Politburo has publicly acknowledged that the trade war with the US will have "substantial impacts" on the Chinese economy, and with trade growth set to slow sharply between the US and China, the IMF has cut its outlook for global GDP by 0.2% for both 2018 and 2019. Aside from that, US Federal Reserve tightening with three rate rises this year and another expected in December, has already triggered instability in a number of emerging market countries, including Argentina, Turkey and Brazil. Whilst China has strengths that set it apart from other emerging economies (e.g. low dollar exposure, small current account deficit, large FX reserves), China is not immune to negative sentiment as seen in the foreign exchange, stock and bond markets.

That sinking feeling…

China's stock market has fallen dramatically over the last six months, falling over 20% and firmly into bear territory. Whilst initially relaxed about the fall, the authorities have recently stepped-up efforts to stem the slide:

13 Oct, first bailout plan from local government: Shenzhen reportedly set up a special fund to bail out companies whose major shareholders have been unable to meet margin calls after pledging shares as collateral.

15 Oct, more local governments issue rescue plans: After Shenzhen's rescue plan, more local governments, including many in Guangdong province and a district in Beijing, prepared rescue plans.

19 Oct, central government voices support: In a rare move, four of China's top financial regulators came out on the same day to announce support for the tumbling stock market.

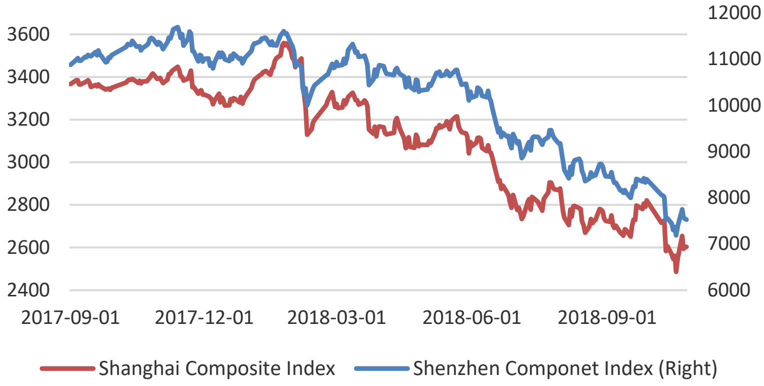

Figure 1. China's stock market *Source: WIND*

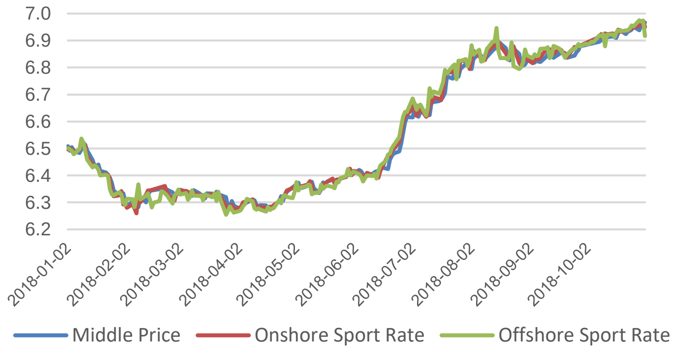

Figure 2. USD/CNY (CNH) Exchange Rate *Source: WIND*

The RMB has also been on the slide and hit a ten-year low against the dollar in October. Speculation is rife as to whether the RMB will break the psychologically-important barrier of seven to the dollar. There is a risk that falling through seven mark may trigger a greater number of Chinese savers to seek to move their money out of China, and trigger a dangerous cycle of falling confidence.

However, increasing numbers of traders and analysts expect the RMB to fall through seven, and indeed the PBoC fix has been close to the line, and RMB futures have already crossed the mark. Most analysts are not expecting RMB to cross seven before a potential Xi-Trump meeting at the G20 but the majority are expecting it to happen before the end of the year.

Indeed, the PBoC has already taken some steps to limit and manage the depreciation. That includes tightening control over the parity rate, the daily range within which the RMB can trade. It has also made it more costly to short the RMB. The PBoC also issued RMB 10bn in three-month bills and RMB 10bn in one-year bills in Hong Kong on 7 November. Authorities say the issuance is aimed at expanding the range of RMB-denominated products of high credit rating in Hong Kong and improve the yield curve. Handily, the issuance also soaks up RMB funds, increases rates offshore and increases the cost of shorting the currency.

China's vast foreign exchange reserves remain its strongest defense: in 2015 and 2016, the central bank spent $1tn propping up the RMB as it first began coming under pressure. Recalling that episode, PBoC Deputy Governor Pan Gongsheng made it clear to speculators on 26 October that the central bank is ready: "For those who are trying to short the RMB, we are very familiar with each other as we fought hand-to-hand a few years ago. I think it's still fresh in our memory" he said at a briefing in Beijing.

Tensions are growing nonetheless in China's bond markets. Monetary policy tightening in the US has increased the relative attractiveness of American assets versus Chinese, with spreads on 10-year government debt down to just 30bps. This is leading to investor outflows. Foreign participation in China's bond market has been steadily increasing since Chinese bonds have been included in major bond indices. In October, however, this trend markedly flattened out after significant outflows offset those mandated to invest due to index inclusion.

Meanwhile, defaults are on the up. 2018 has seen a record number of bond defaults in the private sector, with 28 companies defaulting in the year to-date, more than the last two years combined. Deleveraging seems to be having its first victims. China's local government debt has grown rapidly in recent years, due to pressure to meet economic growth targets and because local authorities are responsible for expenditures they don't have resources for. This has left many local governments dependent on off-balance sheet channels such as Local Government Financing Vehicles (LGFVs). Bonds issued by LGFVs usually get good credit ratings because they have strong support from government. A surprise default by a Xinjiang-based LGFV in August shook investors' faith, however. Two major global rating agencies separately downgraded a combined 11 Chinese LGFVs in mid-September on expectations of weakening support. Both Moody's and S&P note that LGFVs will continue to play an important role due to the systemic risk they present, meaning central government is unlikely to allow large and important government-related issuers to default.

Let a thousand companies bloom

With deleveraging restricting banks' off-balance sheet lending and affecting liquidity, smaller private enterprises are finding it increasingly hard to access finance. Improving funding for smaller companies has become a top priority across the system with Vice Premier Liu He saying that "those who do not lend to the private sector need their politics correcting", while CBIRC Chairman Guo Shuqing has insisted that 50% of new corporate lending go to SMEs. Across the board the regulators have sought to tinker with the financial system to unlock financing for SMEs (see table below).

Table 1. More Actions to increase financing availability to SME

PBoC	Add RMB 150bn of relending and rediscount quotas targeting the financing needs of micro and small businesses.
	Set up policy instruments to support bond financing for private businesses, introducing risk mitigation tools, credit guarantees and other market measures to expand financing access for high-quality private companies.
CSRC	Launch a green channel to support the issuance of "private company special corporate bonds"
CBIRC	Will no longer restrict sectors for equity investment using insurance capital.
	Issued rules clearing insurance companies to invest in stocks through specialised products.
Securities firms	Plan to invest a combined RMB 21bn in a collective asset-management programme to help listed companies ease liquidity pressure amid the recent market rout

Total Social Financing (TSF), a broad measure of credit and liquidity in the economy, however, is sending a worrying signal on future growth prospects. China's TSF includes financing outside conventional bank lending. This grew by a net RMB 2.21tn in September, up from August's figure. The increase, however, was mainly due to special-purpose bonds from local governments now being included in statistics. If these special-purpose bonds are excluded, then TSF is actually falling, hinting at weakening borrowing. The slowdown is likely to trigger further policy easing.

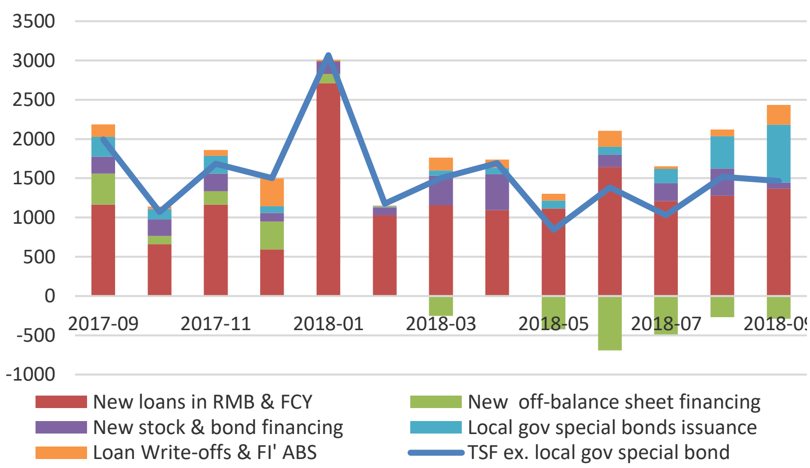

Figure 3. Newly Increased Total Social Finance (Bn RMB) Source: WIND

There have been increasing concerns that the private sector and SMEs are being sacrificed to an ever-growing state sector. “The state advances, the private sector retreats” (国进民退) has become the catchphrase for more conservative elements urging greater control of the economies commanding heights through the SOE sector. Whilst VP Liu He aggressively pushed back on such an approach, the President’s views only came clear in late October through an open letter to the country’s entrepreneurs: “The historical contribution of the private sector to China’s economy is indelible”

Boosting lending to SMEs is easier said than done, and many of the banks are reluctant to toe the line. For one, they remain under pressure to reduce risk, rein in lending and clean-up balance sheets. At the same time smaller businesses lack credit ratings and often lack adequate collateral to access loans. And with a vast SOE sector supported by an implicit guarantee, there is little incentive to turn balance sheets away from guaranteed returns, to riskier revenues.

The development of a Credit Default Swap market though may reduce the private sector’s cost of funding and finally address mis-pricing of risk. According to the PBoC, professional financial institutions will now be able to undertake specific operations, including via Credit Risk Mitigation Warrants (CRMWs) or debt guarantees, to support bond issuance by private enterprises. CRMWs are similar to Credit Default Swaps (CDS). Amid record bond defaults among private issuers, the first two CRMWs were issued. China Bond Insurance sold two CRMWs for ultra-short-term bonds issued by private investment firm Zhejiang Rongsheng Holding Group and cement maker Hongshi Group. The CRMWs helped lower the two companies’ issuance costs. Rongsheng sold its 270-day bond at 4.96%, without the CRMWs a rate as high as 8% or 9% would be expected.

Continued opening up

Set against US trade tensions, the Chinese government has continued to emphasise its commitment to continued opening up. November’s inaugural China International Import Expo in Shanghai was the latest attempt to sell the world on China’s opening and reform agenda. Whilst President Xi’s speech was light on new announcements, China’s financial markets have nonetheless continued to open up to foreign firms, and Governor Yi repeated commitments to deliver ‘national treatment’ for foreign firms operating in China.

Standard Chartered Bank has become the first foreign bank to be granted a domestic fund custody license by the CSRC. With the license, Standard Chartered will be able to directly participate in and provide custody-related services to investment products offered by domestic fund managers.

American Express received PBoC’s preparatory approval for a clearing and settlement license, meaning AMEX can begin work on building a bank card clearing network to process domestic RMB-denominated transactions through a joint venture with Chinese fintech Zhejiang LianLian Technology.

UBS, Credit Suisse and Morgan Stanley are all seeking to increase their shares in their securities businesses to have majority stakes, while Nomura is seeking to enter the market and JP Morgan to re-enter. Both of them want to establish majority-owned securities business, all capitalising on changes earlier this year to allow overseas investment banks to hold majority stakes in joint ventures for the first time. The limit, currently 51%, will increase to 100% by 2020.

And six years after establishing itself as an international offshore RMB trading centre, London now accounts for almost 39% of total RMB trading, according to Swift. By comparison, Hong Kong accounted for 27% in the first quarter, and average daily volumes in the second quarter were up 13.5% on the first quarter.