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China Economics Network

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SUMMARY

After a poor 2018 China's markets had a relatively stable end. The stock market lost a quarter of its value last year but at least stabilised, while the currency appreciated against the dollar on hopes of easing trade tensions. Meanwhile, the central bank is struggling to make the monetary transition mechanism work for private business, as banks just won't to lend to riskier companies. Even though December saw the 40th anniversary of reform and opening-up, hoped for liberalising announcements didn't materialise. We did see some good news in the insurance sector, with two European insurers being granted permission to wholly own their China businesses, three years earlier than expected.

Stock market: high-tech board and stock connect enough to save a troubled market?

2018 saw China's worst stock market performance in a decade. The Shanghai Composite Index, ended the year at 2,493.90, 24.6% lower than its final close of 2017. Shenzhen plunged even further, falling 34.44%. Trading volumes for both Shanghai and Shenzhen were down 20%.

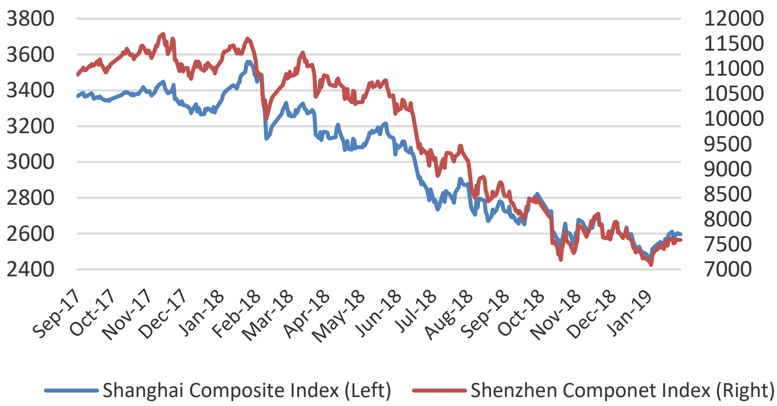

Figure 1. China's stock market performance Source: Wind

There are two equity market developments to look forward to in 2019. One is the new **high-tech board** announced by President Xi during the China International Import Expo (CIIE) in Shanghai in November. The board is an experiment with a registration-based initial public offering system and regarded as part of the government's efforts to expand access to funding for start-ups and fast-growing companies in strategic or emerging industries. In other words, China is hoping more of its domestic tech companies list in China, rather than heading overseas. The board could also attract foreign investors who are being encouraged onshore.

The other is the **London-Shanghai Stock Connect**. The China Securities Regulatory Commission (CSRC) released preliminary rules for London-Shanghai Stock Connect. China International Capital Corporation (CICC) UK has been approved as the first cross-border Global Depositary Receipt brokerage and was followed by Haitong International (UK), Barclays and CLSA. The market is awaiting the launch of the highly anticipated first issuance.

However, despite these two developments the revival of market confidence isn't going to happen overnight and there remain significant risks in the short term, even despite low valuations. China's economy is slowing and the Chinese market can't be shielded from the global turbulence, particularly the trade war.

Monetary policy: is the monetary transition mechanism working?

In 2019, the markets will continue to follow monetary policy developments closely. In 2018 monetary policy in the US and China was often at odds. The Fed hiked rates during the year, while the People's Bank of China (PBoC) introduced a number of tweaks to various facilities designed to provide moderate easing.

Table 1. Fed hikes and PBoC's RRR cut

Fed	*PBoC*
22 Mar 2018 Hike interest rates 0.25%	25 April 2018 RRR cut 1%
14 June 2018 Hike interest rates 0.25%	5 July 2018 RRR cut 0.5%
27 Sep 2018 Hike interest rates 0.25%	15 Oct 2018 RRR cut 1%
20 Dec 2018 Hike interest rates 0.25%	15 & 25 Jan 2019 RRR cut 0.5% respectively

Furthermore, China has been having difficulty channelling finance to the private sector. The PBoC has been attempting to use an increasingly wide array of policy tools to encourage banks to lend but it remains to be seen how successful these can be without more far-reaching reform of the state-owned sector – or else banks will always consider the private sector more risky.

In December, the PBoC introduced a new monetary policy instrument – the Targeted Medium-term Lending Facility (TMLF) – to provide long-term, lower-cost funding specifically for financial institutions supporting small- and medium-sized private businesses. The TMLF will have a maturity of one year, but banks can roll over loans twice, increasing the maximum maturity to three years. The one-year interest rate on the TMLF will be 3.15%, 0.15 percentage points lower than the medium-term lending facility (MLF). The measure, interpreted by some analysts as essentially a targeted rate cut, came hours before the Federal Reserve's widely expected announcement of a quarter-point increase in its benchmark interest rate.

On 2 January, the PBoC announced another mechanism attempting to channel finance to the private sector by widening the eligible companies who can make use of the financial inclusion targeted reserve. By doubling the size of the credit line available more companies can benefit from the scheme and banks are encouraged to lend as they don't need to hold as much capital against these loans.

Finally, the central bank eased monetary policy by cutting banks' reserve-requirements for the fifth time in five quarters. The Reserve Requirement Ratio was cut by a total of 1%, releasing RMB 800bn into the financial system, ensuring an ample supply of cash ahead of the New Year holidays. With growth challenges even more pronounced this year, expect a similar number of moves in 2019. Using the RRR as a tool to target more lending to small companies, however, may not necessarily be effective. As noted above, banks still have few incentives to lend to small, risky companies, many of which lack collateral. Banks are still under pressure from the deleveraging campaign to clean up their balance sheets. Promised fiscal support later this year for smaller businesses in the form of tax cuts could be more effective.

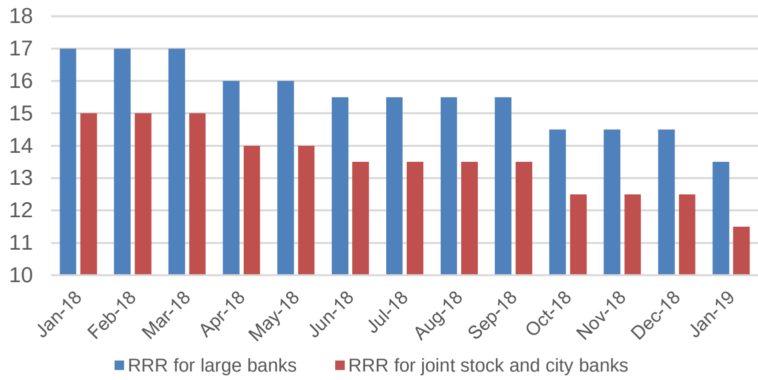

Figure 2. China's RRR for banks (%) Source: PBoC

FX market: after a poor year the RMB has a relatively strong finish

Divergence in monetary policy would usually have a negative effect on the exchange rate. Even with recent turmoil in financial markets, the **RMB has been surprisingly stable, boosted by a weaker US currency and optimism that trade talks are making progress**.

Trade tensions have been the dominant factor on the exchange rate, despite interest rate hikes by the Fed, and slowing economic growth in China. There are signs the Fed may be more cautious about further tightening however, amid concerns about the US economy. That could be good news for the RMB. The dollar index has dropped more than 2% since November and was trading near a three-month low amid waning expectations of further interest rate hikes.

Meanwhile, China's foreign currency holdings rose for a second month, countering some concerns over capital outflows amid a slowing economy and trade pressures. Although much of this is due to revaluations. At least the PBoC didn't seem to sell down the reserves in December, which rose USD 11bn to USD 3.073tn.

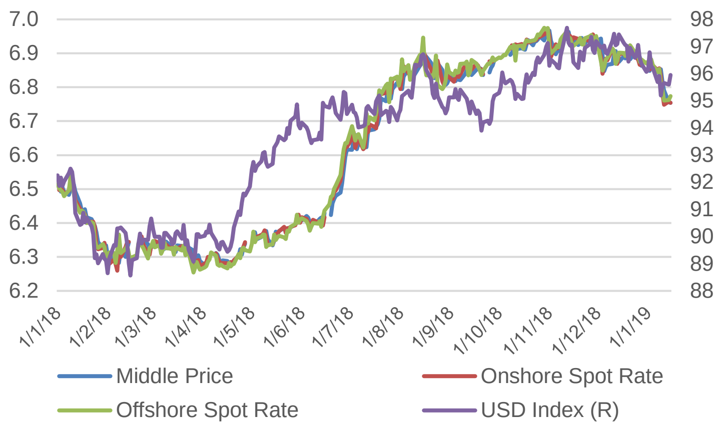

Figure 3. USD/CNY(CNH) exchange rate and USD Index Source: WIND

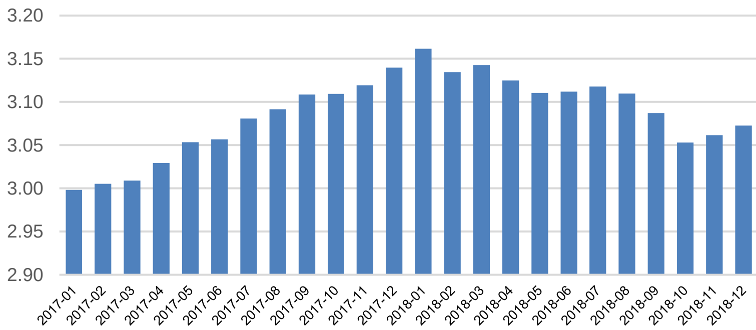

Figure 4. China's FX Reserve (US$tn) Source: PBoC

Financial regulation in the fourth quarter

China's 2018 financial stability report: hinting at the future direction of regulation

The report, published by the PBoC, recognises the risk factors affecting and threatening domestic and global financial stability, which provides clues on the regulators' potential policy direction.

Table 2. China's financial regulatory focus

Regulatory focus	***Details***
Financial holding companies	China will speed up regulations governing financial holding companies to help control their debt risk and high-leverage investments. PBoC will set capital adequacy ratio and debt-to-asset ratio requirements on financial holding firms.
Systemically Important Financial Institutions	China is establishing the regulatory framework of systemically important financial institutions (SIFI). Financial regulators led by PBoC will evaluate candidates from sectors including banking, brokerage and insurance based on their assets, business complexity and how connected they are with others.
Non-bank payment institutions	The report noted how the entrance of multiple third-party payments providers into the market had made clearing less efficient and emphasized the significance of establishing the NetsUion Clearing Platform
Fintech	The report emphasised the risks related to crypto-assets, e.g. market indiscipline induced speculation; lack of the protection of investors' rights and vulnerability to

	crimes. The regulator will still maintain a tough-handed stance on crypto assets and intensify rectification. Various measures need to be adopted to crack down on emerging cases of violation, to safeguard the market order and encourage the flow of funds to the real economy.
Short-term consumer loans	According to the report, the rising cost of purchasing property has dragged on the consumption power of some residents, making them turn to using short-term consumer loans to maintain spending. It is expected that structural deleveraging in 2019 could focus on surging consumer credit.

Banking: plans to set up asset management subsidiaries

China's banking and insurance regulator (CBIRC) has instituted the final version of long-awaited rules covering commercial banks' asset management subsidiaries, with the details underscoring a relaxed stance on how banks can invest wealth management funds. The final rules, which will impact the country's RMB 30tn wealth management product (WMP) market, allow banks' asset management units to raise public stock funds and invest up to 35% of their total assets under management in non-standard credit assets. Until now, Bank of China, China Construction Bank, Agricultural Bank of China and Bank of Communications have won approval from the CBIRC to establish WMP units. Multiple commercial banks are working on plans to set up such units.

Bond market: signs of some unification

Chinese bond market regulators will conduct unified law enforcement in response to violations in the fast-growing market. The central bank and the top economic planner NDRC will play a supporting role in the law enforcement of the China Securities Regulatory Commission (CSRC), according to a document jointly released by the three regulatory bodies. The CSRC is responsible for identifying illegal activity, including insider trading and manipulation in transactions of bonds on the interbank and exchange bond markets, and imposing punishment on violators. For historical reasons, China has a fragmented bond market split between three regulators. These announcements point at some unification, expect more to come but to fall short of full unification.

Continued opening-up

2018 marked the 40th anniversary of reform and opening-up. At celebrations of the anniversary, President Xi vowed to further open-up to the wider world, but that was about it. Sadly, further announcements weren't forthcoming. Nevertheless the fourth quarter did see some signs of promise. The State Administration of Foreign Exchange (SAFE) doubled the quota for the Qualified Foreign Institutional Investor (QFII) programme to USD 300bn, something that has long been called for by international investors. The outbound equivalent, Qualified Domestic Institutional Investor (QDII) programme is much more controlled. Even though SAFE technically reinstated this channel after three years of suspension in April 2018, no new quota has been approved. The government is selectively opening-up, favouring capital inflows.

There have been a number of company-specific measures. Allianz received approval from the CBIRC to establish a fully foreign-owned insurance company in China. Just one day after that, French insurance giant AXA announced it will buy out its partners in its joint venture, AXA Tianping Property & Casualty Insurance. AXA's announcement shows the government is open to moving even faster than what has been publicly stated. Meanwhile, UBS Group AG became the first foreign bank to fully control a Chinese mainland securities firm on Christmas Eve, a major milestone amid global pressure on market access. The Beijing Municipal Government also signed a MoU with SWIFT to establish wholly foreign-owned enterprise in Beijing.