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China Financial Policy Focus – Q1 2015; Four Themes To Watch in 2015

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Banking – New Entrants. China has made good on its November 2013 promise to grant 5 banking licenses to new, private-sector, entrants. These new (probably internet-focussed) banks have the potential to radically alter China's banking landscape – all (bar one) of the incumbents are State Owned Enterprises, and have hitherto enjoyed monopolistic profits. Two of the new entrants are joint ventures with the world's third and fifth largest internet firms: Alibaba (think: e-bay + Amazon), and Tencent (think: Facebook + paypal). Tencent's WeBank was first off the blocks – receiving approval on 4th January this year.

Nervousness about Financial Sector Stability. This is further from the headlines that it was twelve months ago; though the fundamentals have not significantly changed. China is a developing country (with a per capita GDP below Iraq or Algeria) – and the development of its financial system has lagged behind other elements of its economy. Potential triggers to watch are a downturn in the housing market (residential prices quadrupled since 2001), and the buildup of corporate credit (which has doubled as a percentage of GDP since 2008), or a default within China's shadow-banking system which causes systemic panic.

Less well publicised than the risks is the arsenal of tools China has it its disposal to contain any instability; control of virtually all the banking sector (State Owned Enterprises), as well as China's largest firms (also SoEs), large assets (in the form of State-owned assets estimated at 200% of GDP), and more obviously the sovereign wealth funds (45% of GDP), plus some of the world's tightest

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capital controls, and virtually no foreign debt (either corporate nor sovereign). Our best guess (and it is just that) is that any Chinese financial system instability would result in a 1990s-style Japan malaise rather than a '97 Thai-style blow-out.

New Free Trade Zones – Laboratories of Reform. China's long-history of trialling new policies in special-economic-zones could be turbo-charged this year. In December 2014, the government announced three new FTZs (Tianjin, Fujian, Guandong), and a tripling in size of the Shanghai FTZ (extant since 2013). This expansion can be seen as a way to re-energize the FTZ initiative – some felt that the Shanghai FTZ experiment was not delivering fast or deep enough reforms. There will now be creative-competition between the FTZs (and furious behind-the-scenes lobbying) which should lead to faster roll-out of pilot policies. UK businesses in particular will be looking for permissions to have majority ownership of currently off-limits sectors (securities firms, insurance, healthcare, bonded warehousing, education) that the Shanghai FTZ has so far not really delivered.

Stock Markets – "Connect" & "Gyrate"

Gyrations in China's stockmarkets tend to be dramatic: Shanghai fell by 7.7% on January 19th – but the market is still up 70% in the 6 months since June 2014. Bulls point out despite this rally, it is barely half its peak in October 2007. Bears point out that after the previous rally, it lost 70% of its value Oct 2007-2008 – and nearly double what Wall Street lost in 1929. But this is apples and oranges – China's financial system is 80% dominated by bank lending (as opposed to capital markets) – and proportionately, Chinese have much less of their assets in equities. Consequently, China's economy continued to grow strongly despite the 2007 stock-market collapse. We anticipate a few more ups and downs – but that China's economy won't come unhinged by it.

2015 should see additional "connects" modelled on last November's HK-Shanghai Connect (between the world's 10th and 7th largest exchanges by trading volumes). Shenzhen (China's second largest stock market – about half the size of Shanghai's) looks set to follow suit with a HK-connect, having apparently receiving Premier Li's blessing during his visit to Shenzhen's new Free Trade Zone in January. Other nations, including of course the UK, will be vying to be first in line if China's extends these schemes overseas. Another development to watch could be the widening of the existing Shanghai-HK connect to include bonds and commodities.

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Comment

2014 was a busy year for financial sector reform in China: interest rate liberalisation, further capital account liberalisation, continued growth of shadow banking (which some interpret more benignly as financial innovation), and in the final quarter, some monetary policy loosening to spur the economy a little. The central bank this year will need to walk a tightrope; inflation is low (so monetary policy can, and probably will be loosened to support the economy) – but this risks allowing further build-up of debt in the economy.

Overleaf is a more in-depth look at events ahead and a recap of the last quarter, together with some great charts.

Forward Look

2015	Event	Comment
Q1	Further detail expected on China's deposit insurance programme	On Friday 23rd January, PBOC' Vice Governor Pan Gongshen said "Preparation for the deposit insurance has ended, and it will be launched soon,"
Feb ?	Monetary easing via Reserve Requirement Ratio (RRR) cut?	At 7.4%, in 2014 China's economy grew at the slowest rate since 1990 (and China missed its 7.5% target). 2014 CPI inflation was 2%. So there is room for expansionary monetary policy. PBOC cut interest rates in November 2014. The other mechanism used to stimulate credit growth is the RRR. This hasn't been cut since May 2012. If done, it would be to further stimulate the slowing economic growth, plus to provide extra liquidity pre-Chinese new year. [UK hasn't used RRR as a tool since 1981, but it is an important credit management tool for China's Central Bank]
March	Communist Party Annual meetings	Annual meetings of the National People's Congress and Chinese People's Political Consultative Conference – platform for new announcements.
Q3?	Shenzhen may announce a "stock connect"	

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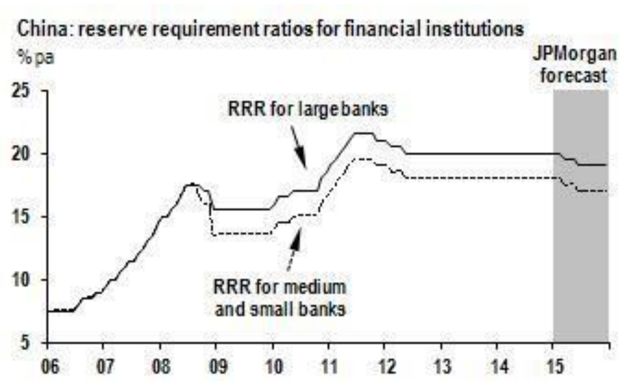

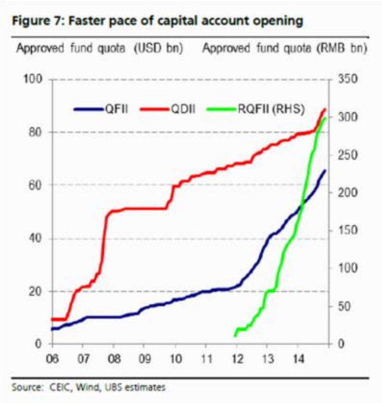

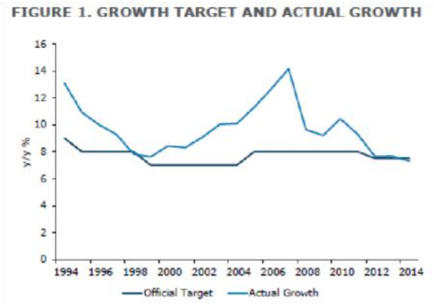

Recent Developments & What This Means

	Event	Comment
Jan	Latest Commercial bank NPL data released: 1.29 % end- Dec 2014. Up from 1.16% at end-October.	[Largest quarterly jump in non-performing loans in a decade] – the ratio is low by international standards (and by China's historical standards) – but the true figure is widely believed to higher.
Jan	19th – 7.7% drop in Shanghai stock market	This was triggered by a tightening in the regulations governing margin trading - regulators are clearly concerned by the growth of illicit margin trading, which has risen rapidly in the last three months.
Dec	National average urban prices fell 4.5% (on previous year) - widening from -3.7% in November.	An acceleration in the rate of fall of house prices. These remain well above the levels 5 years ago, but when a market which has risen this high this fast begins to fall, it triggers wider concerns. (see chart)
Dec	3 Further Free Trade Zones Announced	Tianjin, Guangdong, Fujian join the Shanghai Free Trade Zone (which greatly expanded in size) – all to play for, but foreigners hope that new reforms (including easier market entry for them) will be trialled here and rolled out nationwide.
Dec	Credit growth picks-up (see chart below)	Easing of central bank policy in Q4 in response to lower-than-desired GDP growth. 2014 total credit grew 14.7% - a slowdown from 18.5% in 2013, but credit is still growing faster than GDP, leading to increasing overall debt/GDP ratio.
Dec	Default of real-estate firm's	Kaisa (a Shenzhen developer) defaulted on its offshore bond payments to HSBC.
	offshore bond	Speculation as to the default reason appears that the firm could not get further approvals to develop and sell property due to links to a recently-felled corrupt official.

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Nov	Draft of Deposit Insurance Scheme revealed – consultation.	China doesn't have deposit insurance yet. Introducing a scheme will be important to allowing new (private sector) entrants into banking - and also brings into sharper focus the need to deal with China's weaker (typically small and provincial) banks who have hitherto enjoyed implicit state guarantees. The draft proposes a coverage of RMB 500,000 (£50,000)
Nov	Interest rate cut & Liberalisation of deposit rate cap. & Simplification of rate-setting system.	First in over two years – in response to lower than target growth (and low inflation pressures). One-year benchmark lending cut from 6 to 5.6 %. One-year benchmark deposit rates cut from 3 to 2.75%. Deposit interest rates also partially liberalised – banks can lend 20% above the benchmark rate if they so wish (previously, then could only lend 10% above this rate). They also scrapped limits on interest rates for long-term deposits of five years, and simplified its system of benchmark rates for loans.
November	Shanghai-HK "Stock Connect" launched	Flows into China have outpaced flows out of China. Perhaps unsurprising, as "international" stocks in HK (e.g. Prada, Glencore) are not included in the programme – which gives access to HK firms and Chinese firms listed in HK.

Downturn in Property prices

Recent uptick in credit growth

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FIGURE 1. PROPERTY PRICE INDEX

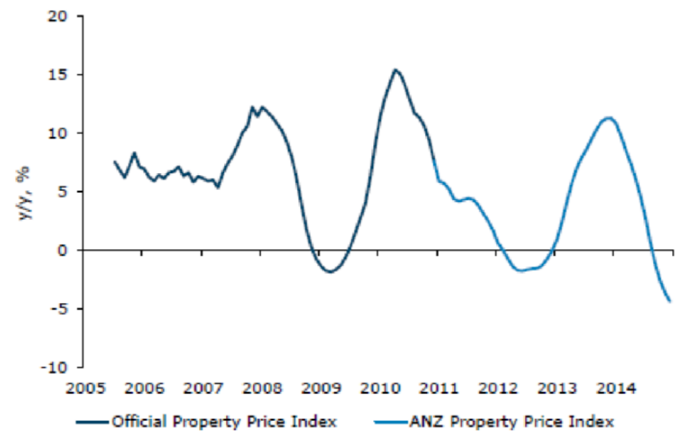
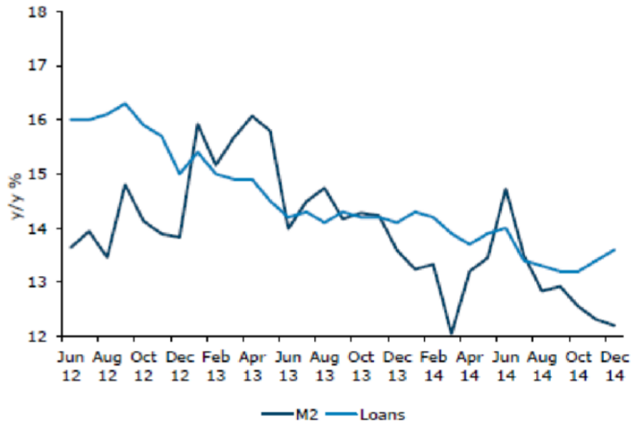


FIGURE 4. M2 AND CREDIT GROWTH



Growing Debt

2014's stock market surge in context

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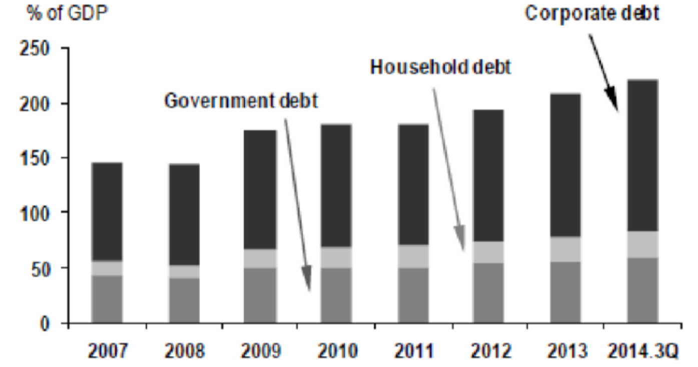
Chart 22: Total social debt



Source: CEIC, J.P. Morgan