Financial System

The Story So Far

Modern economies rely on complex financial systems to support growth and prosperity. At an earlier stage of development, China succeeded despite an immature financial system, as state-led investments in sectors such as infrastructure generated high returns. Today’s requirements are more complicated, and the risks are apparent. China’s financial reform goals include improving efficiency (return on investment) and reducing systemic risk while attempting to preserve state influence. China has made progress, but long-standing tasks remain unfinished as the cost of retiring old liabilities swells and new risks emerge. The 2013 Third Plenum Decisions promised market-driven liberalization of the system in the form of additional entry opportunities for smaller and private financial institutions, market-driven interest rates and exchange rate formation, and additional capital account liberalization.

- Regarding interest rate liberalization, Beijing removed a floor on lending rates in July 2013. In 2015, Beijing gradually increased the ceilings that banks could offer on deposit rates and then removed them entirely in October 2015. While formal constraints have been lifted, banks continue to limit full market pricing of deposits, reportedly because of informal guidance from regulators.

- Exchange rate liberalization has progressed along a rocky path, as there is still considerable evidence of People’s Bank of China (PBOC) intervention in the foreign exchange markets. After a poorly communicated adjustment to the currency’s daily fixing mechanism produced a shock depreciation in August 2015, RMB movements have become much more volatile. While markets have a freer hand to adjust the RMB’s value, the central bank’s intervention is also persistent, reducing benefits of market determination.

- In late 2016, Beijing launched an aggressive deleveraging campaign to reduce systemic financial risks that were accumulating from the growth of shadow banking activities. Despite a slowdown in economic growth, the campaign has continued, substantially reducing credit growth in China and tightening regulations around the financial system.

- Foreign investors’ participation in China’s financial markets has increased, and Beijing is encouraging foreign portfolio inflows in particular, with the expansion of programs such as the Bond Connect and Hong Kong–Shanghai Stock Connect starting in 2015. In 2018, foreign investors were key marginal investors in China’s government bond market and exercised significant influence over China’s domestic interest rates. In April 2019, Chinese securities were added to the Bloomberg Barclays Global Aggregate Bond Index, a major benchmark for global bond investors, for the first time.

Methodology

To gauge the state of financial system reform, we construct a quarterly incremental capital output ratio (QuICOR) as an acid test for efficiency; then we discuss the policies giving rise to this picture. The indicator tells us how much investment occurs relative to one unit of output growth: a lower ratio is better, with 3.5 recognized as high quality internationally, according to International Monetary Fund (IMF) guidance. To supplement this analysis, we look at other indicators, including total credit growth rates, the ratio of stock and bond financing to less direct channels, interbank lending rates, return of household savings, and foreign bond holdings.

Quarterly Assessment and Outlook

Primary Indicator: Incremental Capital Output Ratio
4qma, ratio value

![Graph showing Incremental Capital Output Ratio]


- Our assessment is neutral this quarter, with reform indicators moving in both directions. Our primary indicator shows the financial system becoming less efficient, while efforts to lower systemic risk have reduced murky shadow banking activity.
Credit growth picked up in 1Q2019 as Beijing eased monetary conditions to stabilize the economy in response to a domestically rooted slowdown and external trade-related uncertainty.

Marginal financial sector liberalization is occurring even as trade tensions build, with pledges to remove equity caps on foreign investment in securities and insurance. Bank default risks are being priced more efficiently by the market after regulators took over Baoshang Bank (after the review period), but implicit guarantees still impede reform.

This Quarter’s Numbers

China’s financial efficiency faltered marginally in 1Q2019, with our primary indicator, the Quarterly Incremental Capital Output Ratio (QuICOR), rising to 7.29 from 7.21 in 4Q2018. Capital expenditures are generating less economic output growth, with gross domestic product (GDP) expansion at the slowest pace since the global financial crisis. As gross capital formation has slowed in the last six months, our indicator will improve later this year as long as overall growth stabilizes. Nevertheless, still twice as much capital is required to generate the same output growth in China as in best-practice nations. This is the legacy of high debt levels and implies that politics continue to trump market forces in allocating credit, reducing returns to new investment.

Overall Growth in Credit picked up to 10.7% year-on-year in 1Q2019 from 9.8%, as the PBOC added liquidity to the banking system and steered money market rates lower to counteract a slowing economy. This modest rebound in credit growth does not necessarily impede financial reform. After an extreme contraction in shadow financing channels in 2018 under Beijing’s deleveraging campaign, some boost in credit growth was to be expected for countercyclical management. Current credit growth in the 9%–10% range is far below the 16.6% growth seen three years ago. Because China’s financial system is enormous—with over $40 trillion in bank assets—it will not likely return to previous growth levels. Even so, the pace of credit growth once again exceeds nominal GDP growth, meaning that China is adding to economy-wide leverage rather than moderating the debt load.

Consistent with the pickup in credit growth, private sector firms enjoyed improved access to financing this quarter. Corporate financing primarily took the form of lower-interest and short-term bill financing loans—often used for working capital. However, after the difficulties the private sector endured in 2018, it will take more than a few quarters to establish confidence that Beijing is ready to level the playing field for private firms, which are benefiting less than their SOE cousins from easier money.

The PBOC eased monetary policy as a countercyclical tool to boost growth, resulting in a significant decline in money market rates during the review period. As a result, shadow banking funding costs have dropped close to the level of banking system funding costs over the past three quarters (see Interbank Lending Rates). Offering rates on Yu’e Bao investments, the country’s biggest money market fund, which we use as a benchmark in our indicator of financial repression, dropped to 2.53% in 1Q2019, down more than 160 basis points in a year (see Return on Savings). This decline indicates that risky shadow banking investments were less attractive relative to more standard products and deposits, which is a positive for financial reform even though it translates into less interest income for depositors.

Supplemental 1: Growth in Credit

<table>
<thead>
<tr>
<th>Year</th>
<th>TSF YoY</th>
<th>Loan YoY</th>
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<tbody>
<tr>
<td>2018</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>2019</td>
<td>16%</td>
<td>9%</td>
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Source: People’s Bank of China.
Policy Analysis

Better market-driven pricing of credit risks is an essential component of financial reform, by breaking the implicit guarantees that are widespread across China’s financial system. The most significant development for financial reform was the sudden takeover of Baoshang Bank, a reasonably large city commercial bank in Inner Mongolia, on May 24. While the exact cause precipitating the takeover remains unclear, regulators’ decision to seize the bank signaled that bank defaults on corporate and interbank deposits are now possible. The net result of the first bank default since 1998 has been a market scrambling to price potential risk, with large banks refusing to lend money to smaller banks or nonbank financial institutions in the interbank market, out of fear that they could be the next Baoshang. So far, authorities have restructured two other banks—Bank of Jinhzhou and Hengfeng Bank—facing severe funding stress in the fallout from Baoshang’s takeover.

New bank default risks are now being priced by the market, which is a positive step. But by providing ad hoc liquidity assistance and guarantees to other banks affected by the fallout from Baoshang, regulators undermined the reform signals they had sent. In addition, the resulting rise in funding costs for smaller banks and nonbanks resulting from the injection of counterparty credit risks after Baoshang’s default may widen the gap between formal bank and shadow bank financing rates, reopening regulatory arbitrage opportunities.

As financial risk emerges, fuller interest rate liberalization becomes more crucial to the course of reform. Presently, bank funding costs are mostly fixed by
the benchmark deposit rates set by the central bank (as shown in Return on Savings). This creates the regulatory arbitrage opportunities that gave rise to shadow banking and other financial risks. Unified funding rates for the banking system allow the central bank to influence credit conditions in the economy more directly through changes in monetary policy, which is closer to a developed market system of managing interest rates. Ultimately, the goal is to see lending rates determined by market forces rather than State Council preferences.

So far, however, deposit rates have not risen in 2019, even as money market rates have fallen sharply. China is expected to announce additional steps toward interest rate liberalization in the second half of 2019, but the scope remains unclear due to bureaucratic conflicts. Eliminating benchmark deposit and lending rates once and for all, or explicitly basing them on a market rate, would represent significant steps forward for market pricing of capital in China’s financial system.

The most important policy variable to watch at present is Beijing’s appetite for financial sector opening to foreign participation, even as leaders emphasize self-reliance in response to trade tensions. Both Premier Li Keqiang and PBOC Governor Yi Gang have committed to additional brokerage and insurance industry opening to foreign firms without equity caps. Premier Li reiterated these commitments at the Dalian World Economic Forum, proposing a 2020 deadline. Such pledges date at least to 2017, but progress has been limited. JPMorgan and Nomura received approvals to establish majority-owned brokerage joint ventures this year, following earlier approval for UBS, and Allianz won approval for a wholly foreign-owned insurance holding company. However, a myriad of procedural hurdles remain; payments firms Mastercard and Visa still face obstacles even seven years after Beijing promised to abide by a World Trade Organization decision insisting they be allowed to operate.