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

- We slightly upgrade our assessment. The first effective bank default at Baoshang Bank marks an important step toward market pricing of credit risk.

- Our primary indicator showed the financial system becoming less efficient even as economic growth moderates. Credit growth is stable for now but may slow as banking sector risks weigh on shadow banking activity.

- The central bank shifted official lending rates to a more market-based system. However, there were no meaningful steps toward reform of deposit rates or
unifying bank funding rates to prevent regulatory arbitrage.

This Quarter’s Numbers

On balance, financial indicators showed no change in reform progress this quarter, though we expect data will reflect positive policy developments over the next year. Our primary indicator continues to show deteriorating efficiency within China’s financial system. The Quarterly Incremental Capital Output Ratio (QuICOR) rose to 7.41 in 2Q2019 from 7.21 at the end of 2018, reaching its highest level since at least 2011. The broader slowdown in China’s economy, from 6.4% year-on-year real GDP growth to 6.2% in 2Q2019, drove the QuICOR’s rise, rather than resurgence in capital growth. In fact, in the first half of 2019, capital formation accounted for its smallest-ever share of real economic growth, consistent with a tighter post-deleveraging financial system. Even so, capital produced less new economic output this quarter.

Overall Growth in Credit picked up early this year in response to monetary-easing steps and continued rising in 2Q2019 to 10.9%. The deleveraging campaign to reduce systemic financial risks has continued in China, but the pace of that effort has moderated since the middle of 2018, allowing credit growth to rise. This is not necessarily a negative signal for financial reform, as the sharp slowdown in shadow financing growth last year was not sustainable without a significant increase in financial risks. Current credit growth in the 9%-11% range is far below the 16.6% growth seen only three years ago, though it still adds to economy-wide leverage rather than moderating the debt load.

Consistent with continued People’s Bank of China (PBOC) monetary easing, shadow banking funding costs have dropped close to the level of banking system funding costs, with the spread between our two indicators narrowing to only 7 basis points (0.07%, see Interbank Lending Rates). This is due to a slight increase in banks’ funding costs this quarter. By tolerating a bank failure in May (Baoshang Bank), Beijing caused big banks to be more conservative lending to smaller institutions, starting to push up the price of credit for riskier players. This is necessary and—ultimately—healthy, though it means stress in the near term.

Regulators advanced more market-driven interest rate reform this quarter, but household savings in China still see the same policy-controlled rate of return on their deposits (see Return on Savings). Until the PBOC allows banks to offer more market-driven returns on deposits, interest rate reform will remain incomplete and incentives driving riskier financial behaviors will remain in place.
Better market-driven pricing of credit risks within financial institutions is an essential component of financial reform by breaking the implicit guarantees that are widespread across China’s financial system. In this respect, the takeover of Baoshang Bank by regulators was an important positive reform step. Corporate and interbank depositors lost money as a result of the seizure, exposing depositors to the credit risk of the bank itself for the first time since 1998. As a result, banks have reduced interbank lending activity, with larger banks more reluctant to provide financing to smaller and riskier banks out of fear they will not be paid back in full. This can help reduce overall financial system growth over time by winding down some of the riskier institutions within the system.

Since Baoshang’s takeover, two other banks have been restructured—the Bank of Jinzhou and Hengfeng Bank—and more will likely follow. The most important question for financial reform will be how authorities manage those bailouts, and where the costs are distributed throughout the financial system. Some market discipline is necessary to prevent banks from relying on riskier liabilities to expand, but too much could lead to rapid liquidations of assets and a contraction in credit. New measures aim to slow banking system growth and prevent future defaults. The asset management rule, which will be fully implemented by the end of 2020, will force banks to meet stricter capital adequacy requirements. Beijing is also placing more pressure on banks’ shareholders by limiting banks’ interbank exposure as a proportion of their total capital base. These policy changes indicate a desire to contain financial risks despite the potential impact on overall economic growth.

Financial system liberalization is proceeding: the PBOC has continued to strongly encourage foreign investors to increase their holdings within China’s bond and stock markets. In September, the State Administration for Foreign Exchange scrapped formal limits on inbound flows under the Qualified Foreign Institutional Investor (QFII) program. The move is symbolically important, but its practical impact is minimal given that more flows transact through the Hong Kong–based Bond Connect and Stock Connect channels. In addition, PBOC Governor Yi Gang commented in September on the importance of China maintaining a conventional monetary policy stance while other global central banks are reducing rates and pursuing unconventional policy measures. Presumably, his comments are intended to attract foreign inflows by arguing that Chinese interest rates will be higher than those in the rest of the world. This indicates a continued willingness to liberalize the domestic financial system and permit greater foreign influence in setting domestic
interest rates, even though the current level of foreign investment remains low (for example, only 2.1% in the bond market; see Foreign Held Bonds).

While foreign investors have long pushed for more open access to China’s economy, which features one of the largest bond markets in the world and a growing stock market, increasing exposure to China’s financial markets through bond and equity index inclusion has also prompted backlash in the United States. Earlier this year, a bipartisan group of U.S. congressional representatives called for government pension funds to disinvest from indexes that track Chinese companies that are linked to “China’s efforts to steal American innovation, undermine fair competition, increase threats to U.S. national security and economic security,” according to Senator Marco Rubio. At present, however, there seems to be little momentum for action to impede U.S. outflows into Chinese assets.