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

- We downgrade our financial reform assessment from positive to negative for 1Q2020. China has leveraged its financial system to combat the COVID-19 crisis, urging banks to extend loans and prevent defaults. This is negative for financial reform and efficiency, even if necessary as a temporary measure to kick-start growth.

- Our primary indicator showed a sharp decline in financial efficiency as new credit to the economy rose while first quarter GDP fell by 6.8% year-on-year (yoy). These trends will reverse in 2Q2020 because growth has rebounded.

- Regulators continued to pressure shadow banking institutions, even after defaults at trust companies and smaller banks, and cracked down on speculation in financial markets.

This Quarter's Numbers

Our primary indicator, the **Quarterly Incremental Capital Output Ratio** (QuICOR), rose rapidly in 1Q2020, indicating that China's financial system got worse at pricing capital and risk efficiently. As activity shut down under COVID-19, China's banks deployed financial resources aggressively to prevent an even sharper growth contraction and avoid more defaults and bankruptcies. Because negative GDP growth causes our primary indicator to give a faulty reading, we adjusted the QuICOR by using an assumption of zero GDP growth in the first quarter. The revised primary indicator rose from 7.36 in

4Q2019 to 7.51 in 1Q2020, which understates the actual rise in financial system inefficiency.

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

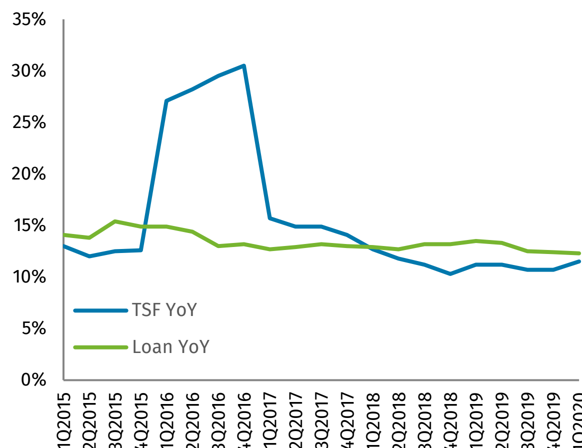
Source: International Monetary Fund, National Bureau of Statistics, Rhodium Group.

Falling returns on new capital are a setback to financial reform, especially if China's banks continue to roll over loans and extend forbearance through 2020 and into 2021. Doing so creates nonperforming asset problems, which banks are left to deal with on their own. Watch for this in the second half of 2020.

While **Growth in Credit** picked up slightly from 10.7% to 11.5% in 1Q2020, shadow banking continued to contract, due to tighter regulations, particularly targeting trust companies. Regulators are focused on reducing financial risks despite the slowdown in the economy and are trying to boost official credit, while also adding new regulations to keep informal shadow financing in check. To ease financial system pressure and help institutions manage funding costs, the central bank has guided short-term interest rates lower. Funding rates for nonbank institutions fell to a 1Q2020 average of 2.26% from 2.65% in 4Q2019, and bank financing rates fell sharply to 2.11% from 2.50% (see **Interbank Lending Rates**).

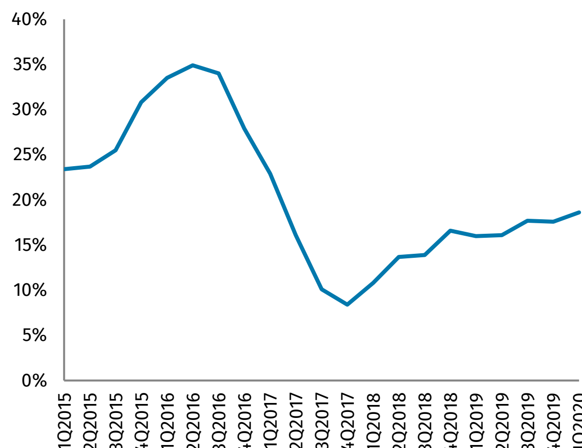
Foreign institutional investors moved money out of China during the COVID-19 outbreak: China's financial markets were not viewed as a safe haven. However, this had a greater impact on the equity market than the bond market, as the share of foreign holdings in China's bond market remained unchanged at 2.2% in 1Q2020 (see **Foreign Held Bonds**), a low level compared with that in advanced economies.

Supplemental 1: Growth in Credit
Percent



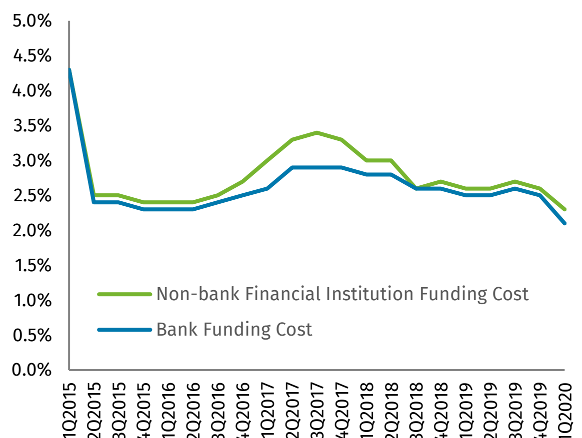
Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio
4qma, percent



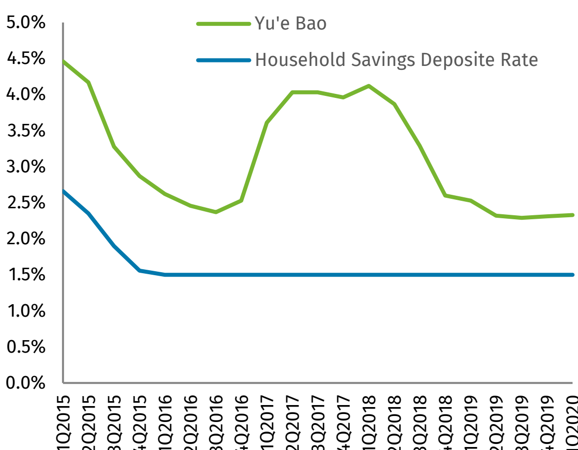
Source: People's Bank of China, China Securities Regulatory Commission.

Supplemental 3: Interbank Lending Rates
Quarterly average, percent



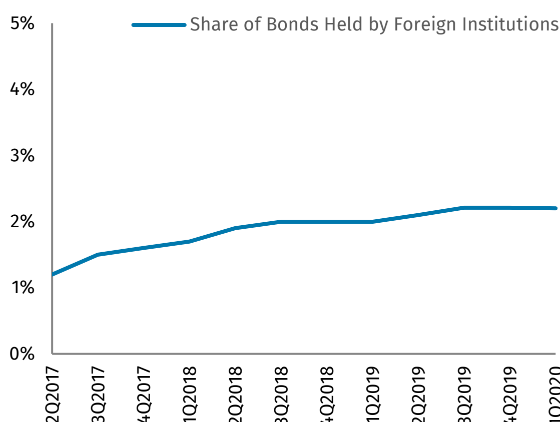
Source: National Interbank Funding Center, China Central Depository & Clearing Co.

Supplemental 4: Return on Savings
Quarterly average, percent



Source: People's Bank of China.

Supplemental 5: Foreign Held Bonds
Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

Policy Analysis

Some emergency expansion in credit was inevitable as a response to the COVID-19 outbreak and its economic consequences. As such, financial reform intentions and policy signals will be hard to interpret this year.

One risk to financial reform is that banks will be too lenient with firms struggling to repay debt. Highly indebted firms were already saddled with nonperforming loans, and in some cases defaulting, even before the COVID-19 outbreak. The crisis is now being blamed for debt problems that in fact were building up for years. Banks can only do so much in extending new loans to zombie companies—they are already short of capital and their balance sheets are stretched. Authorities have guided banks to extend forbearance for distressed borrowers until March 2021, but this appears to be too long given that China's economy returned to growth in 2Q2020. Should this guidance continue or be extended, it will be a profoundly negative signal for financial reform.

On the positive side, authorities continue to make some effort to clean up speculative financial activities and shadow banking channels. When short-term funding rates fell in March and April, some firms found an easy arbitrage opportunity by borrowing at those lower rates and offering money at higher rates through other channels. After a concerted regulatory effort and a slight rise in short-term money market rates in May and June, those arbitrage opportunities have declined in 2Q2020, which should reduce speculation to some extent.

China's shadow banking sector is showing new signs of trouble, with several trust companies facing protests from angry investors frustrated with losses from defaulted products. Rather than cave into these investors, Chinese authorities have tightened regulations to restrict trust firms from issuing new products. The result has been a slowdown in shadow credit in 2Q2020, consistent with efforts to control illicit financing. At the same time, frustrated investors who saw new risks emerging in China's shadow banking system chose to redirect funds into the equity market, potentially starting a new bubble.

On balance, financial reform has been heading in the wrong direction since the COVID-19 outbreak as banks faced pressure to ignore the usual credit risks in making loans. Investors are now starting to see the prospect of losses in more asset categories, a positive step toward removing implicit guarantees in China's financial system. The greatest risk to the limited financial reform progress we have seen so far is a prolonged relaxation of regulations and lending criteria to respond to the economic disruption of COVID-19, rather than a temporary easing of rules to get over the immediate blow from the crisis.