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, and inclusions in two other major bond indices have followed.

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 maintain our slightly negative assessment from the previous quarter, as Beijing is still instructing the banking system to support distressed borrowers to combat the post-COVID economic downturn. Even if necessary in the short-term, this delays progress toward market-driven allocation of credit.

- Not surprisingly, given the COVID-19 crisis, our indicator shows a significant decline in financial system efficiency in 2Q2020. More credit has been needed to forestall a sharper slowdown.

- There are some signs of progress in reducing over-reliance on banks for so much financing and better market pricing of credit risk: corporate bond issuance increased even as defaults are rising, and foreign purchases of China's bonds went up.

This Quarter's Numbers

Financial system efficiency deteriorated in 2Q2020. Our primary indicator, the **Quarterly Incremental Capital Output Ratio** (QuICOR), rose sharply, to a level way above international norms. After the shock of COVID-19, China is still piling on more financing and generating even less growth.

(Methodology note: Because the contraction in China's GDP due to COVID-19 produced a faulty reading in the QuICOR in 1Q2020, we used zero GDP growth instead. This approach understated the fall in China's financial system efficiency in 1Q2020. Now that the economy has returned to positive growth, we revert to using the official 3.2% GDP growth rate this quarter.)

In response to the impact of COVID-19, Beijing encouraged credit growth and urged banks to give borrowers (particularly small and medium enterprises) flexibility in repaying debt. **Growth in Credit** picked up to 11.5% year-on-year (yoy) in 2Q2020, compared with 10.7% in 1Q2020. That has prevented a sharper economic decline, but at the cost of deteriorating asset quality at banks. As deteriorating assets are recognized on balance sheets, banks will be unable to grow credit at the current pace.

New credit has been driven by government and corporate bond issuance, rather than a surge in new loans, which only expanded by 12.3% in 2Q2020, slightly slower than in 1Q2020. Direct financing from the bond market has improved because of the overall decline in interest rates since the beginning of the year. The **Direct Financing Ratio** rose to 20.2% in 2Q2020, its highest level since 1Q2017.

Money market interest rates, or the cost of borrowing for financial institutions, fell very sharply early in 2Q2020 due to central bank easing. The interest rates for bank-to-bank financing and for nonbank financial institutions declined (see **Interbank Lending Rates**). However, in May and June, rates stabilized and then rebounded, as the People's Bank of China (PBOC) tried to squeeze out frenzied market speculation. The effort to clamp down on speculative trades should be viewed as a positive signal for financial reform.

While foreign institutional investors initially moved money out of China as the COVID-19 outbreak hit, by the second quarter, investment in Chinese stocks and bonds rebounded. Nevertheless, foreign investors' share of total bondholding only rose from 2.2% to 2.3% (see **Foreign Held Bonds**). The increase is modest due to the large expansion of overall corporate and government bond issuance. Foreign inflows should continue to rise, given the recent addition of China's securities to the FTSE Russell index.

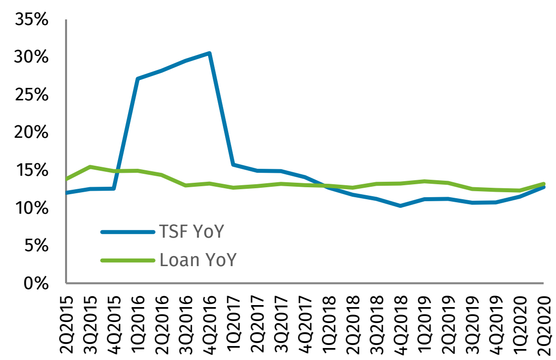
Primary Indicator: Incremental Capital Output Ratio

4qma, ratio value

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

Supplemental 1: Growth in Credit

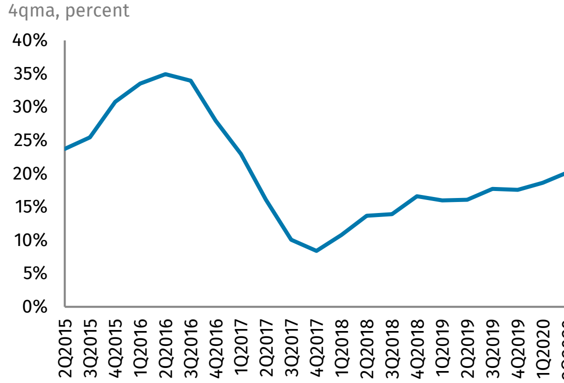
Percent



Source: People's Bank of China.

Supplemental 2: Direct Financing Ratio

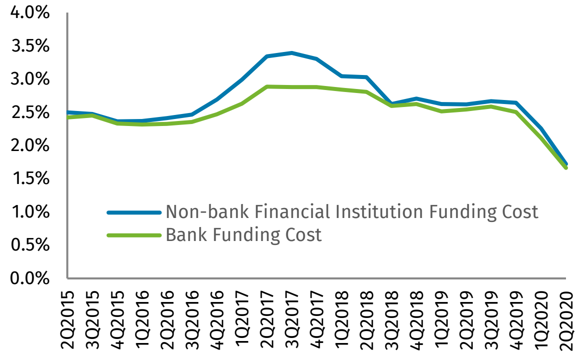
4qma, percent



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

Supplemental 3: Interbank Lending Rates

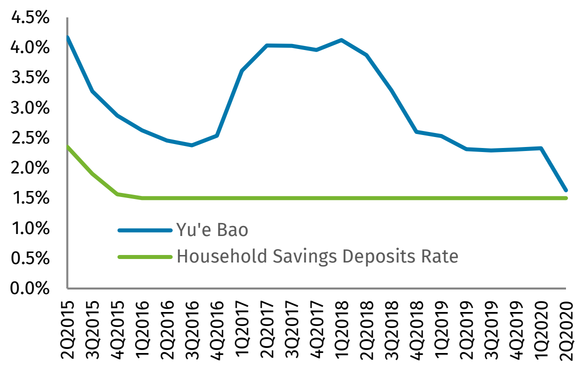
Quarterly average, percent



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

Supplemental 4: Return on Savings

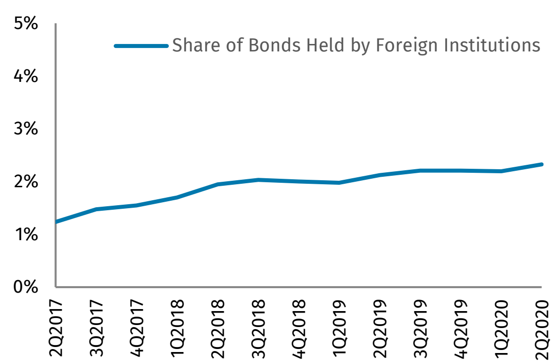
Quarterly average, percent



Source: People's Bank of China.

Supplemental 5: Foreign Held Bonds

Quarterly average, percent



Source: ChinaBond, Shanghai Clearing House, Rhodium Group.

Policy Analysis

On balance, the COVID-19 outbreak put system-wide financial reform back on hold. While some progress was made in opening the market to foreign bond and equity investment, Beijing is leaning as heavily as ever on banks to support distressed borrowers. That is antithetical to our definition of financial reform.

Beijing lowered border investment barriers, a necessary step for inclusion in the FTSE Russell index. Specific improvements made in September included extending trading hours in China's interbank market to accommodate European investors, easing capital repatriation restrictions, and giving foreign investors in the interbank market access to the exchange-traded bond market. More corporate bonds trade in the exchange-traded market, giving foreign investors access beyond government and policy bank bonds.

Beijing continues to focus on shadow financing risks, particularly in the property sector. New PBOC and Ministry of Housing and Rural Development (MOHURD) regulations limit property developers' balance sheet growth, starting with larger developers. These are meaningful restrictions on shadow financing because developers are major borrowers from nonbank institutions. With the PBOC's continued squeeze on arbitrage trading, this shows commitment to reducing shadow banking risks.

The major setback for financial reform in China right now is that the largest financial institutions — commercial banks — are increasingly acting as state policy tools rather than as profit-oriented institutions. This is a step backward after previous efforts to encourage market-driven lending. Smaller rural commercial banks are struggling with nonperforming loans and raising new capital, which prevents them from extending old loans or offering new loans to troubled small and medium enterprises (SMEs). Authorities have guided banks to extend forbearance for distressed borrowers until March 2021 and may extend this further. This is a big negative for the financial reform outlook.

In addition, the recent postponement of Ant Financial's initial public offering has rekindled concerns about sudden state intervention in the private sector. The move does represent a setback for financial reform but also reflects legitimate regulatory issues in China's digital economy, including the boundaries between state and market influence over credit pricing, the use of consumer data, and anticompetitive practices in financial technologies. The state is now reasserting some of the boundaries that private firms such as Ant had successfully broken down.

As credit risks build, leaders face limits on using administrative tools to manage financial stress. Default risks are rising, particularly in corporate bond markets: even bonds issued by local government financing vehicles are defaulting, and investors are questioning local governments' commitment and capacity to repay their debts. That is actually positive for reform because it means bad choices are punished, but Beijing faces a delicate balancing act in enforcing market discipline while preventing a broader pullback in lending.

Final Dashboard Assessment

China's 2013 reform agenda pledged more market-driven allocation of resources and pricing of capital, a more flexible exchange rate regime, and openness to foreign investors. Since then, system-wide financial efficiency has deteriorated. Too much credit is allocated to inefficient state-owned enterprises and local government financing vehicles, whose debt burdens rise relative to the size of the economy.

The interest rate regime has changed fundamentally since 2013, but administrative controls remain in one form or another, limiting the opportunity for financial institutions to price capital. Exchange rate liberalization has also stepped backward: there is considerable evidence of PBOC intervention to manage swings in the currency, and political considerations continue to heavily influence rate movements.

China has made the most progress in two areas: opening to foreign portfolio investors and controlling shadow banks and informal financing channel risks. Some of this progress has been reversed since the COVID-19 outbreak. Fears of capital control reimposition remain an obstacle to larger foreign inflows, and overall foreign investment has barely expanded as a proportion of China's market.