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SUMMARY

A more stable quarter for China's markets, though Brexit brings renewed concerns about RMB depreciation. Stock market share suspensions a major barrier to inclusion of Chinese A-Shares in the MSCI Emerging Markets Index. US-China Strategic Economic Dialogue another stepping stone in capital markets liberalisation. However debt and financial stability concerns growing, with regulators clamping down on shadow banking sector. Growing concerns that rapid market liberalisation may increase financial stability risks.

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Brexit ripples through China's markets

A quieter quarter for China's markets though Brexit referendum result brings renewed downward pressure on the RMB. China's stock markets dropped 1.3% on the back of Brexit, though recovered all those losses the following day. More significant was the decision by the PBOC to set its daily RMB rate at the lowest level since 2010, and 0.9% depreciation against the US dollar.

Nonetheless, the RMB has depreciated 3% over the last quarter against the dollar, and 6% against the trade weighted basket. Whilst improved communication on the exchange rate setting system, including a commitment to maintain stability against the trade weighted basket, has helped to increase stability, continued depreciation is testing credibility of the new regime. Capital outflows abated from February onwards in part because of stricter implementation of existing rules on outflows, but balance of payments 'errors and omissions' (indicators of households and firms moving currency out of the country through illegitimate means) remain persistently high at around $40-$60bn a month.

In the stock market nonetheless, trading volumes are significantly lower than last year. Average daily transaction registered RMB181.9billion in the last quarter, compared to RMB700-800billion over the same period last year.

Capital markets liberalisation continues

In a much anticipated decision, on the 14 June Morgan Stanley Capital International (MSCI) decided against inclusion of China's A-Shares into its Emerging Markets Index. With US$1.5tn in global funds tracking the index, inclusion would have been a significant step on the global stage for the A-share index, though by only allowing partial inclusion initially it would only be expected to facilitate between $20 and $30bn of inward flows in the short term (0.8% of China's average monthly trading volume).

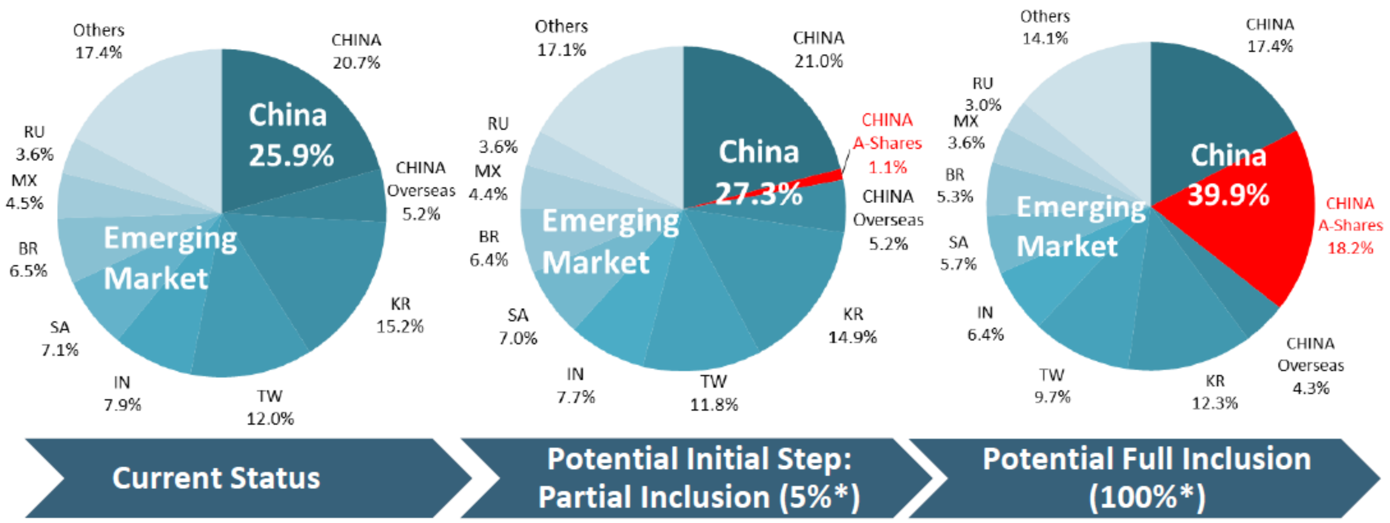

Figure 1: *Source: MSCI, "Consultation on China A-Shares Index Inclusion Road Map", April 2016*

Over the last year, CSRC has taken steps to address MSCI concerns in particular over recognising the rights of beneficial owners of securities, broadening and simplifying allocation of QFII quotas, and allowing daily repatriation of QFII funds. However, limits on monthly repatriation of funds through the QFII scheme needs addressing.

Bigger barriers to inclusion are the scale of voluntary suspensions of A-share trading over the last year, and the requirement that China's stock exchanges pre-approve all financial products (including ETFs) linked to an index containing China A-shares. The scale of share suspensions remains a primary concern for international investors concerned about being locked into positions. Whilst the Shanghai Stock Exchange has sought to provide greater clarity on circumstances of suspension, including a requirement for firms to apply in advance, MSCI will wait to see how the new rules are implemented. CSRC are also concerned to control the extent to which offshore trading develops around indices tracking the A-share market. Whilst no direct capital link from such indices to the mainland, concerns remain that such offshore activity can indirectly and significantly impact confidence and volatility in the mainland market.

Building on February's ground breaking announcement to open the Chinese interbank bond market to foreign private investors, in June the PBOC followed with detailed guidelines. Importantly, the guidelines confirm quota-free access and set out a registration, rather than approval, process for foreign investors to access a market worth $7.4tn and expected to grow to $20tn by 2025. Foreign participation in the market currently stands at only around 2%, mostly led by central banks.

The final US-China Strategic and Economic Dialogue of the Obama Administration also yielded further progress on financial services liberalisation. This included granting a RMB200bn ($38bn) RQFII quota for US firms, the second largest quota after Hong Kong, and an announcement to establish a RMB clearing bank in the US. Equally significant was language acknowledging that CSRC would gradually increase foreign ownership levels for securities and fund managers, currently capped at 49%, along with encouraging signs regarding AMAC approval for a number of wholly foreign owned firms applying for permission to start undertaking business in China.

Growing concerns around debt and financial stability

China's debt burden remains a pressing and growing challenge for Chinese policy makers. In May this year the *People's Daily* published an interview with anonymous 'authoritative insider' who warned that high leverage was China's 'original sin'. Whilst total debt is equal to 225 percent of GDP, corporate debt alone accounts for around 145% of GDP. The IMF's Article IV visit to China focused explicitly on the risks arising from China's corporate debt.

Profitability is declining, bond issuances are being postponed, and bankruptcies and defaults are rising. In the first half of the year there have been 34 recorded defaults (compared to 5 in 2014) in the interbank bond market with total value of around $3bn (around half of the $6tn market is in corporate bonds). First quarter bankruptcies rose 53% year on year to 1,028, compared against a total of 20,000 cases from 2008 to 2015. Bond issuance cancellations and postponements are also up, with cancellation of a $15bn bond issuance in April this year causing spreads to rise substantially. Debts are particularly concentrated in a small pocket of state owned enterprises, with Moody's estimating that bringing down the leverage of the top 10 per cent of most heavily indebted SOEs to median levels would cost as much as 20 to 25% of GDP.

Reflecting the worsening trend, banks are increasingly hiving off poor performing assets to asset management companies with sales to Cinda and Huarong (two of China's largest asset managers founded in 1999 to deal with bad assets following the Asian Financial Crisis) increasing threefold in the last year.

The PBOC's annual Financial Stability Report also highlighted concerns over growth in the shadow banking sector. Bloomberg estimate that the shadow banking sector grew 30 per cent last year with assets now totalling 80% of GDP. Part of this growth is due to the ballooning internet finance sector which now accounts for 20% of all China's banking sector assets and 30% of all loans according to the PBOC. Complex wealth management products (WMPs) backed by non-financial institutions have also ballooned in recent years as savers chased higher yields. Deutsche Bank estimate that smaller Chinese banks are most exposed to this sector (22% of assets exposed) compared to larger banks (3%), with 40% of Bank of Ningbo's

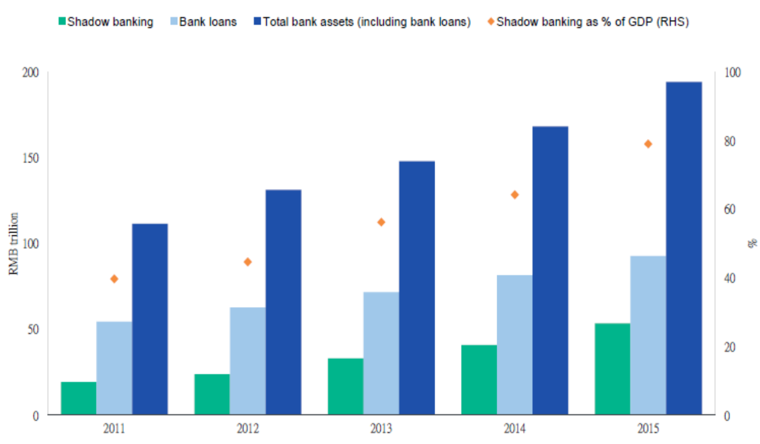

Figure 1: Growth in China's banking assets as % of GDP; *Source: Moody's, "China's Shadow Banking Sector, System Growing at a Faster Rate, Overall Leverage is Rising", May 2016*

assets (BONB) in the shadow banking system. These small local banks are the weakest link in China's financial system, and are where financial stability risks would most likely first materialise.

Responding to these concerns, the regulators have set stricter capital and provision requirements, and capped the leverage of off-balance sheet special purpose vehicles. The recent clamp down is also part of the explanation for a slowdown in broad credit growth this quarter (21% reduction in new loan growth compared to last year) following a burst at the start of the year.

Proposals for a debt for equity swap to tackle the debt situation continue to split opinions within Government with the 'authoritative insider' warning against such a measure. Concerns remain that pricing such swaps will be difficult given the inability to distinguish between zombie and fundamentally healthy companies. Bankruptcies and insolvencies help on both counts and the People's Supreme Court recently published ten corporate bankruptcy cases as models for judges nationwide to use as templates for handling such cases. However a long awaited revision of the 2007 bankruptcy law is still pending and uncertainty remains on creditor rights.

Growing concerns around financial stability is resulting in increasing pressure from some quarters to slowdown capital markets liberalisation. A broad consensus amongst analysts remains that a financial crisis remains unlikely given that China has a large trade surplus, sizeable (though shrinking) foreign exchange reserves, and most debt is domestically held. At the same time, volatility over the last year has given greater to cause to those parts of the system warning that rapid financial liberalisation risks leading to financial crisis. Ongoing rebalancing and restructuring of China's economy will add more stress to the banking system, and will likely further raise the tension within government on financial liberalisation.