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# China Financial Policy Focus (Q1, 2016)


## SUMMARY

**Turbulent start to the year with Chinese stock markets shutting down twice in the first week and the offshore exchange rate dropping to its lowest rate in five years. Significant global impact from volatility reflects growing spillover from Chinese markets. Substantial efforts by PBoC and CSRC to improve communication help restore calm. Thirteenth five-year-plan restates commitment to financial reforms, with recent developments, including bold liberalisation of the bond market, prioritising inward flows. Growing pressure to tackle non-performing loans and reform regulatory architecture.**



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*We encourage readers to get in contact for further information on any points covered in this note, or to suggest ways of improvement*

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## New Year, New Volatility

**China's stock and foreign exchange markets welcomed the New Year with renewed and extreme volatility. Echoing last summer, stock market volatility and changes to exchange rate policy triggered turbulence, but a fundamental change in global investor sentiment on the health of Chinese economy added new pressure.**

**On the opening day of the year, China's CSI 300 fell 7%, tripping the market's newly installed circuit breaker and shutting down markets early for the day. Two days later, markets droped again and shut down within half an hour.** Weak manufacturing data, looming expiration of a ban on share sales imposed on China's largest shareholders, and a newly installed circuit breaker all stoked investor anxiety and fuelled market volatility. In a repeat of last summer, China's 'National Team' of securities firms renewed share purchases to prop up the market and the PBOC eased monetary conditions. In addition, the circuit breaker was scrapped and the share sales ban extended. By the end of the month, the Shanghai Stock Exchange Composite Index had dropped around 25 per cent.

**Compounding the volatility, the RMB came under enormous downward pressure in part due to yet another major adjustment to its exchange rate, with the offshore rate hitting its lowest point since April 2011.** Whilst pre-announced last December, at the start of the year the People's Bank of China (PBoC) formally introduced a new system for setting its daily central parity rate for the onshore RMB. In particular, the RMB exchange rate would now be set against a basket of major currencies. This change in part was in response to IMF recommendations related to last year's SDR inclusion suggesting that greater flexibility in RMB exchange rate would help to close the gap between the onshore and offshore rates.

**Unclear communication however led to many investors to interpret the move as preparing the ground for major devaluation of the RMB**. Whilst the gap between the onshore and offshore rates had been increasing since last November (indicating that offshore investors are more bearish on China's economy than the onshore rate allows), the gap hit a record level in January.

**Volatility in China's stock markets had a profound global impact.** The FTSE100 index in the UK and S&P500 in the US both fell by 10 per cent in the opening month of the year, despite both economies having very limited direct exposure to China's stock markets. The IMF in a recent report judges that substantial spillover effects from China on global markets are likely to continue as the rest of the world gradually embraces RMB assets.

## Easter Calm

**China's markets have stabilised substantially since February, partly as a result of improvement in economic indicators, but also greater efforts by the Chinese authorities to build credibility of the RMB exchange rate regime through better communication with international investors.**

PBoC Governor Zhou Xiaochuan in his New Year interview with Caixin Magazine on 14 February, shed light to the motivation for exchange rate adjustment saying that: *"China remains committed to exchange rate reform and aims to have the RMB broadly stable at an adaptive and equilibrium level"*. While the Governor re-emphasised commitment to finding a market equilibrium level for the RMB, he also stressed that due to market defects, guidance would be necessary to avoid the currency deviating from a reasonable trajectory. Fang Xinghai, newly-installed Vice Chairman at China Securities Regulatory Commission (CSRC), was also dispatched to Davos in late January to discuss recent events in China. Stanford educated, fluent in English and refreshingly candid in admitting mistakes and poor communication by the Chinese authorities, Fang's contribution also helped to reassure agitated markets.

**The PBOC has also been keen to dismiss ideas of a competitive devaluation, and has stressed, rightly, that measured against a basket of currencies, the RMB has been broadly stable** through 2016Q1. Indeed, on trade-weighted terms, the RMB has in fact appreciated 12.5 per cent from 2013, whilst staying stable against the dollar until last August. A weaker dollar since February also helped to ease pressure on the RMB.

**Nevertheless, risks remain in both the RMB exchange rate and Chinese stock markets.** There is still more to do to enhance the credibility of China's exchange rate regime, especially as pressure and questions grow over the government's capacity to rebalance the economy away from investment. There also remain a large number of intervention measures in the stock markets which need to unwind over the coming year (see Fig 1). Rumours of unwinding interventions have previously resulted in extreme market volatility and that is likely to also be the case in the future.

| MEASURES | CURRENT STATUS |
|---|---|
| 21 leading securities firms 'voluntarily' promised to mobilize at least RMB120bn to invest into blue-chip ETFs, and hold assets until Shanghai index reads 4500. | Market still below 4500 but since Nov 2015 firms allowed to sell positions |
| China Securities Finance and CSRC together aided the above 21 securities firms with RMB520bn credits | (as above) |
| CSRC suspended IPOs to limit supply of new stocks | IPO resumed since Nov 2015 but IPO registration reform postponed (see later) |
| China Financial Futures Exchange increased margin requirement to 30% for short selling of CSI 500 Index Futures | Requirement maintained |
| CSRC imposed a lock-up period of six months on major shareholders who hold more than 5% of a stock | Original expiry date 8 Jan triggered panic. Since extended indefinitely |
| State-owned Assets Supervision and Administration Commission (SASAC) required around one hundred central SoEs to buy in stocks and not sell out | Already phased out |
| China Securities Finance (CSF) directly invested in both blue-chips and small-cap stocks | CSF now among the top 10 outstanding shareholders of hundreds of firms with substantial paper loss |

**Fig 1:** Range of interventions in the Chinese stock markets

## Capital Flows

**Capital outflows remain a concern but the pace has started to slow.** China's FX reserves fell USD28.6bn in February, around one third of January rate, to reach USD3.2tn. At the same time, FDI (inward flows) increased 4.5% year on year to USD35.4bn.

**Part of the reason for reduction in outflows is due to a de facto tightening up on capital controls to close regulatory loopholes.** In addition the PBoC imposed an upper limit of USD5,000 per transaction on retail investors who buy insurance products overseas via credit card. As well as legitimate transactions, this route had also been heavily used as an expedient means to move capital out of the country.

**Greater clarity on the nature of capital outflows has served to calm some of the negative market sentiment.** In particular, research by BIS, Goldman Sachs, UBS, Capital Economics and Dragonomics have all identified unwinding speculative inward flows as well as Chinese firms paying down foreign debts as major drivers of capital outflows since 2015.

**Furthermore, a surge in Chinese overseas direct investment (ODI) is likely to contribute to continuing and expanding capital outflows.** In 2016Q1, announced overseas acquisition deals by Chinese firms amounted to USD100bln, roughly equivalent to last year's total.

## Policy Outlook: The 13th Five-Year Plan

**Whilst volatility may impact pace of reform, the message from Chinese authorities is that they remain committed to reform in the financial sector.** In his Caixin article, Governor Zhou stressed: "*There are good times and bad times [for reforms]. At good times, we firmly push progress forward; at bad times, we could wait a bit, and try to create conditions that are more favourable [for reforms]. We do not expect a smooth sailing, and we are clear about the importance of keeping a good balance between reform, development and stability*." **The 13th Five-Year-Plan also made clear that financial and capital markets will play a key part in the 'supply-side reform' story.**

**Firstly, a 'prudential and relatively accommodative' monetary policy, higher fiscal deficit ratio (>3 per cent), and debt-for-bond swap programme, are all designed to facilitate economic rebalancing and restructuring.** The first two months of 2016 saw surging credit growth, with both January and February having around 15 per cent year-on-year jumps to release as much as RMB3,237bln to the economy. The local government debt-for-bond swap programme is also expected to help free up local government fiscal room for 'supply-side reform'.

**Secondly, authorities still intend to construct a "multilevel capital market" to enhance direct-financing for real economy, including further development and opening-up of the bond market.**

**On 24 February, People's Bank of China announced that 'medium' and 'long term' foreign private sector investors could for the first time invest in China's giant interbank bond (IBB) market without using quotas.** Sovereign wealth funds, central banks and international financial institutions were granted the same type of access last summer. Development of the IBB market is part of China's strategy to diversify financing and reduce concentration risks from reliance on bank funding. This is a significant step towards liberalisation, and whilst near term uptake may be slow, JP Morgan estimate that the China market could attract as much as 10% of global fixed income investment.

**December also marked the first approvals under the China-Hong Kong mutual recognition of funds scheme, a milestone that enables cross-border sale of funds that are domiciled in the two markets.** There are currently 25 Southbound funds (Chinese funds selling into HK) and 6 Northbound funds (HK funds selling into China) that have been approved, a significant imbalance in approvals by the two regulators. This reflects broader issues HK funds have encountered when applying for CSRC approval, including opaque decision-making, stringent requirements on jurisdiction that funds are sold in, eligibility of even simple types of products, and licensing requirements.

**A long awaited reform of the IPO system however was delayed yet again.** The IPO registration reform is intended to lower threshold for IPO activities by replacing CSRC examination process with a simple registration system. Nonetheless reform remains on the agenda, with CSRC having taken meaningful steps to improve institutional readiness for IPO registration reform, including the enforcement on information disclosure which has, for the first time, led to delisting of offending companies.

**Thirdly, in order to tackle the growing problem of non-performing loans, authorities floated an initiative for Chinese banks to swap the debt they hold in underperforming companies for stock holdings.** Market rumours suggested that a pilot programme would be announced to swap as much as RMB1tn non-performing loans into stock holdings by Chinese banks. Whilst such arrangements could help buy time for companies in temporary difficulty to undertake necessary supply side reform, there is a risk of creating moral hazard and greater systemic risks in the banking sector.

**Finally, there is increased focused on financial regulatory reform to improve coordination amongst China's different regulators.** With Chinese firms taking on increasing cross-sector and cross-market financing activities there is a pressing need for more effective coordination in the regulatory system.