December 2016

Foreign & Commonwealth Office

China Financial Policy Focus (Q4, 2016)

China Economics Network

Ting Su
Financial Policy Advisor, British Embassy Beijing

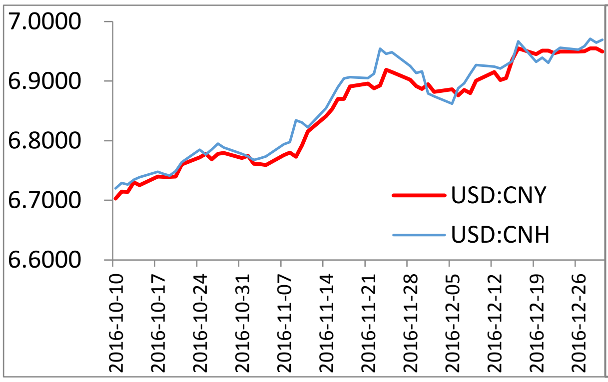
Kunal Khatri
First Secretary Financial Policy, British Embassy Beijing

SUMMARY

A surge in capital outflows in the last quarter of 2016, with foreign reserves heading to their lowest level since March 2011. RMB depreciation against the dollar and a weakening outlook for China's economy remain the key drivers of outflows. Growing concerns on outflows and depreciation lead to a tightening of the capital account. At the same time the PBOC has increased efforts to tackle excess liquidity and hidden risks in the shadow banking sector. This carries risks as demonstrated by a seizing up and correction in China's bond market. The Central Economic Working Conference emphasises stability over reform, and vigilance on systemic financial risks.

RMB depreciation continues

Over the last quarter the RMB continued to depreciate against USD but remains stable against a basket of currencies (using RMB indices as proxies). In particular, since the RMB officially joined IMF Special Drawing Rights in October, the RMB has depreciated to an eight year low against the dollar (Figure 1). An increasing number of Influential economists publicly call for a one-off devaluation (10-20%) of RMB against the USD, whilst others remain concerned that sudden depreciation could lead to a dangerous spiral and risk financial instability. The PBOC remains committed to managed flexibility, with the annual Central Economic Working Conference concluding that RMB should become more "elastic" yet remain "broadly stable at a reasonable equilibrium".



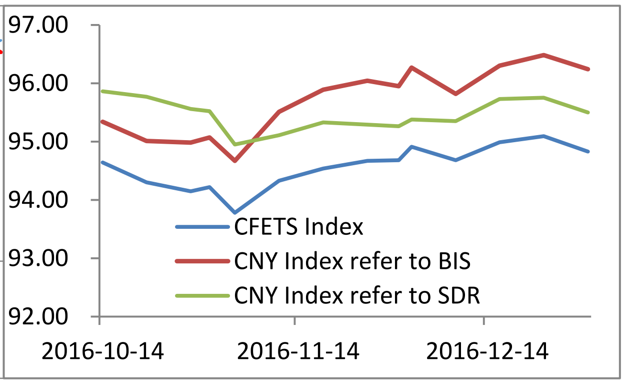


Figure 1 (L): CNY and CNH exchange rate against USD; Figure 2(R): RMB indices. Source: WIND

A weakening offshore market mirrored concerns onshore, with USD/CNH (offshore RMB against dollars) reaching 6.97 on 30th December. Despite RMB capital outflows from the mainland, deposits in Hong Kong continue to shrink indicating that currency leaving the mainland is being converted into foreign currencies. The volume of trade settlement in RMB has also fallen since last August though has recently stabilised (Figure 3). Dim-sum bond issuances (offshore RMB bond) have also fallen to a quarter of the 2014 level.

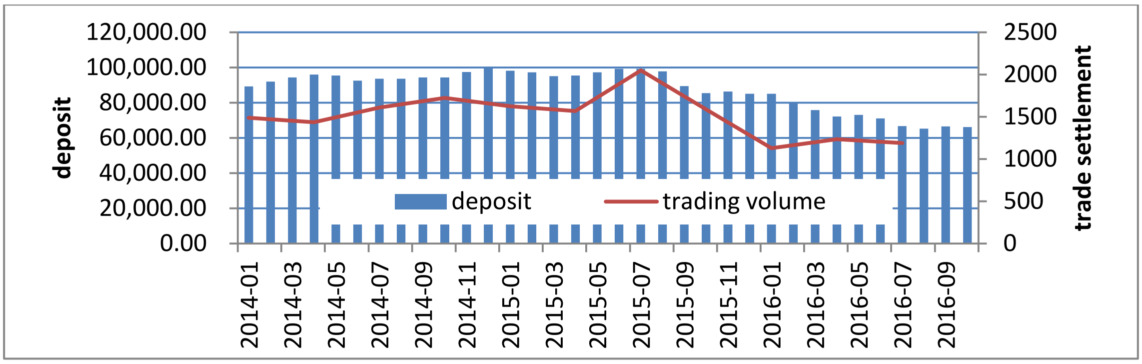
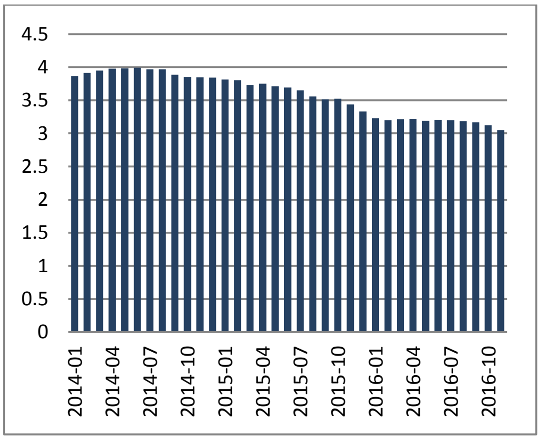


Figure 3: Offshore RMB in Hong Kong (trillion USD). Source: WIND

Growing concerns over capital outflows

After a slowdown in outflows over the summer, capital outflows jumped again in the last quarter at around $25bn a month. China's foreign exchange reserves have fallen almost $800bn over the last year to nearly $3tn, their lowest level since March 2011 (Figure 4).



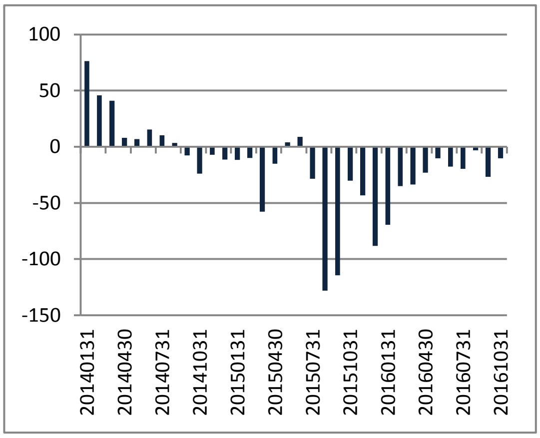
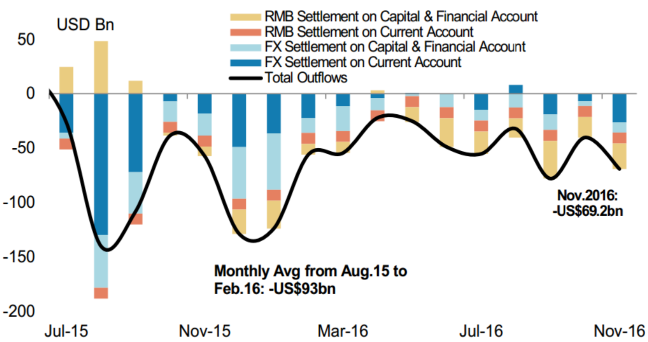


Figure 4 (L): Foreign reserves (USD tn); Figure 5 (R): Net foreign-exchange purchases for clients by banks (USD tn). *Source: WIND*



Source: SAFE, Morgan Stanley Research

Figure 6: Estimated total cross-border outflows accelerate in November

Bank lending and securities investment accounted for $301bn in net outflows from China in the first nine months of the year, compared to $78bn from outbound direct investment. The net foreign-exchange purchases for clients by banks, a proxy for differences between the demand for foreign and domestic currencies, has been negative for 16 months (Figure 5), reflecting companies' low appetite for holding RMB. Furthermore, 'errors and omissions' in the balance payments, typically an indicator of households and firms moving currency out of the country through illegitimate means, remain high (-495 billion RMB in Q3). Morgan Stanley estimate however that monthly cross-border outflows between Mar-16 and Nov-16 are still lower than Aug-15 to Feb-16 (Figure 6).

The government has sought to tighten capital controls in response to continued outflows. This includes further tightening in ODI, with the State Administration of Foreign Exchange (SAFE)'s increasing scrutiny over any transfers abroad worth $5 million or more in either RMB or foreign exchange, and major outbound deals worth over $50 million. In addition tighter restrictions have been introduced on residents' overseas spending via credit card, and administrative burdens on foreign currency settlement over $50 million have been increased even if firms have approval.

On 30th December, the State Administration of Foreign Exchange (SAFE) announced more scrutiny on individual foreign currency purchase in anticipation of renewed downward pressure on the RMB in the New Year. Starting Jan. 1, Chinese individual FX purchasers must first fill out an application form specifying the purpose of the purchase, among other information. As well as being subject to closer scrutiny by SAFE, the new rules also prohibit foreign currency purchases for the purpose of cross-border real estate, security life insurance and dividend-paying insurance.

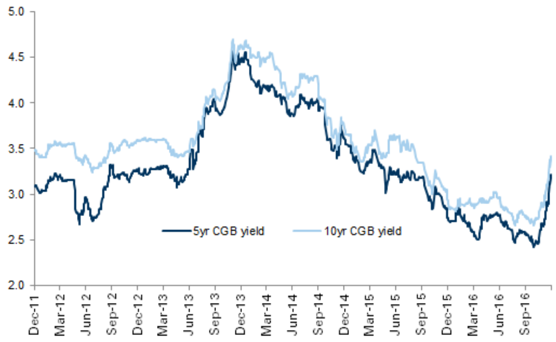
These new measures alone will not substantially impact outbound flows but an increasing number of economists are pressing for stricter rules on currency conversion and any other potential channel for the moving the currency. The PBOC Governor, Zhou Xiaochuan, has himself declared that these measures would be "temporary" in order to stabilize the market, and that capital account reform is still on its track as evidenced by the long awaited launch of the Shenzhen-Hong Kong stock connect. However, both the Shanghai and Shenzhen stock connect schemes are closed-loop systems, and as such investment flows do not represent capital outflows.

Growing risks in the financial market

PBOC's third quarter financial stability report has brought increased attention on risks in the system, and in particular a growing maturity miss-match between the asset and liability side. Concerns are growing over increased reliance on PBOC for short term liquidity funding on inter-bank market, with the PBOC's Q3 Monetary Policy Report indicates that the trading volume of over-night money surged this year to 87.8%, with smaller banks increasingly and heavily reliant on short term funding.

Since August the PBOC has deliberately sought to constrain short-term liquidity and inject long-term liquidity into the market through open market operations. This has resulted in rising interest rates for short-term inter-bank borrowing and rising bond yield, leading to a substantial correction in the China inter-bank bond market (Figure 7). China's 10-year and 5-year Treasury bond futures recorded their biggest ever drops in early trading, falling by 2% and 1.2%, respectively. The US Federal Reserve decision to increase interest rates added to the stress with the PBOC having to resort to injecting emergency liquidity to the market. Another incident send more shocks to the already volatile bond market and even caused trust crisis between banks and non-banks was a brokerage refused to honour a bond transaction worth 10 billion RMB because its staff used fake seal on the contract. Credit bond defaults have also accelerated this year, with new bond issuance also falling substantially (Figure 8).

Whilst tightening liquidity is necessary, it will add stress to the financial system and the PBOC will have to balance the need to reduce liquidity and the need to maintain stability.



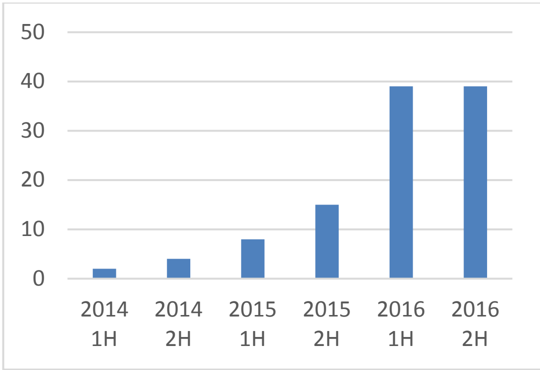


Figure 7 (L): 5yr and 10 yr China domestic government bond yield; Figure 8 (R): Number of bond defaults. Source: WIND

Underpinning the highly leveraged bond market is the enormous growth in wealth management products (WMPs), driven in particular by smaller local banks. WMPs have provided banks with a means to increase off-balance sheet leverage and invest in high yield (and riskier) assets, without having to hold capital against them. The complexity of these products, and the opaque chain of banks, trusts and securities firms that form the investment chain create substantial risks in the system.

In response, the PBOC has decided to include WMPs into its macro-prudential assessment starting from 1 January 2017. The CBRC is also seeking to curb risks of shadow banking through a new *Guideline on Banks' Off-balance Sheet Risk Management* (draft), which revises the 2011 version and seeks to expanded the definition of bank off-balance sheet business and set higher capital requirement for risk-weighted assets, including for WMPs.

Outlook for 2017

Ahead of next year's National People's Congress and leadership elections, economic stability will be paramount. The government's Central Economic Working Conference in December signalled that stability over growth would be the key priority in 2017. Prevention of financial instability has become a more prominent policy priority with a focus on controlling asset price inflation and fixing regulatory weaknesses. Calls for a 'prudent and neutral' monetary policy also point towards further tightening, as does a commitment to increase exchange rate flexibility.

Whilst it is unlikely that there will be bold announcements on capital markets liberalisation, the government nonetheless remains committed to greater liberalisation and market reform. However a growing number of influential economists and commentators within China are urging greater caution and it is likely this debate will become more intense in the year ahead.