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Focal Point

China: How much cooling is Beijing likely to tolerate?

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- The US-China trade war looks set to escalate. US President Trump will most likely impose a 25% tariff on another US$ 200 bn of imports from China. China will use its available space for retaliatory measures worth US$ 60 bn.
- The trade conflict comes on top of China's regulatory tightening of the shadow banking sector, which has already led to a negative credit impulse but affected the real economy so far only by slowing infrastructure investment.
- Given this double risk, China is likely to recalibrate its economic policy:
- We expect monetary policy to further ease liquidity in order to offset the negative impact from regulatory tightening on credit growth, but not to give up on its de-risking program altogether.
- We see fiscal policy in charge to mitigate the negative impact from the trade conflict in order to protect the 6.5% 2018 growth target. For 2019, we stick to our 6.2%-6.3% growth forecast, assuming China's reform agenda to be held up.

The US-China trade war looks set to escalate. According to press reports, US President Trump will most likely impose a 25% tariff on imports from China worth US$ 200 bn (while repeating his threat to tax about all of imports from-China). The measures will probably come into effect rather quickly, after the public hearing period ended on Sept. 6, with rumors of the exact timing varying between only a few days and during September. The new tariffs come on top of the already implemented sanctions of US$ 50 bn, which China fully retaliated. This first round alone reduces China exports by around 0.2% of annual GDP. A rough and ready calculation suggests that the much larger new round will cut into the export value by 0.9% of GDP. However, the ultimate GDP effect depends on a wider range of factors: The depreciation of the yuan against the US-dollar will mitigate the price impact of the tariffs in dollar terms and thus help reducing the export volume effect. Secondly, China has a share of more than 30% of processing imports, which will also reduce the GDP impact (but also imply negative repercussions on Asian exporters). China responded to the US$ 200 bn list with an own list of tariffs on US goods of US$ 60 bn (which broadly uses up the remaining import value). In contrast to these mitigating factors, a limited negative impact on investment cannot be excluded. All in, we estimate a negative growth effect of about 0.75 pp of annual GDP. In addition, we see only little chances that this conflict will calm down soon.

Trade war comes on top of credit risks

The trade conflict comes on top of rising headwinds from the regulatory tightening of China's shadow banking sector. While the clash with the US caught Beijing much by surprise, the second risk factor stems from a high ranking policy decision. Since the Great Financial Crisis, China's non-financial sector debt rose by about 120 pp to 253% of GDP in 2017. Amid this credit boom, shadow banking also expanded substantially, obscuring credit risks to a point, at which China started to roll out a comprehensive set of new financial regulations (the regulatory tightening). This now covers about every shadow banking channel. The strategy dates back to 2016, but gained momentum institutionally by setting up the Financial Stability and Development Committee (FSDV) directly under the State Council (Nov. 2017) and by merging the banking and insurance regulators to one Regulatory Commission (Mar 2018).

Overview of the new regulatory framework

Covering every aspect of the financial system

Entrusted loans	Trust-bank cooperation	Asset management business	Mutual/Money market funds
· 14tn in outstanding · New rules: Jan 18	· AuM of the trust sector: 24tn · New rules: Dec 17	· AuM: c.100tn · New rules: Apr 18, Jul18	· Mutual AuM: 11tn, o/w 5tn MMFs · New rules: Aug 17

Monitoring every aspect of banks' behaviour

Banks' risk exposure	Trust-bank cooperation	Asset management business	Mutual/Money market funds
· New rules: Mar 18	· New rules: Jan 18	· New rules: May 18	· 67tn in outstanding · New rules: Jan 18

Adopted from SG Cross Asset Research/Economics. All numbers are end-2017 RMB reading. Source: PBoC, CBIRC

Merits and risks of China's shadow banking

As described in a recent BIS paper, China's shadow banking sector essentially serves three functions. First, on the ultimate borrower side, it provides credit more easily to pri-

vate firms. Traditionally, state-owned banks prefer to lend to large state-owned enterprises (SOEs) due to their implicit state guarantee, while private firms, smaller SOEs, local government financing vehicles (LGFV) and property developers have more difficulties to access formal lending. Moreover, the corporate bond market is also well supported by shadow banking funds. The funds are basically raised by banks on from the ultimate creditors (households, firms, institutional investors) mainly via Wealth Management Products (WMPs) as well as Trust Products, incentivized by higher returns than typical bank deposits. And finally, on the credit intermediation side, it provides the opportunity to bypass stricter banking regulations. In fact, in China – unlike other countries – banks are the dominant players in the shadow banking system, therefore the sector is also dubbed the “shadow of the banks”. While the large SoE banks receive the bulk of regular deposits, smaller joint stock and city banks are typically most active in the WMP market. Funds from selling WMPs are channeled into the banks’ wealth mangagement arms and securities firms as well as trust companies. The latter also receive additional funds by special trust products. These funds are then off banks’ balance sheets which reduces the regualtory burden.

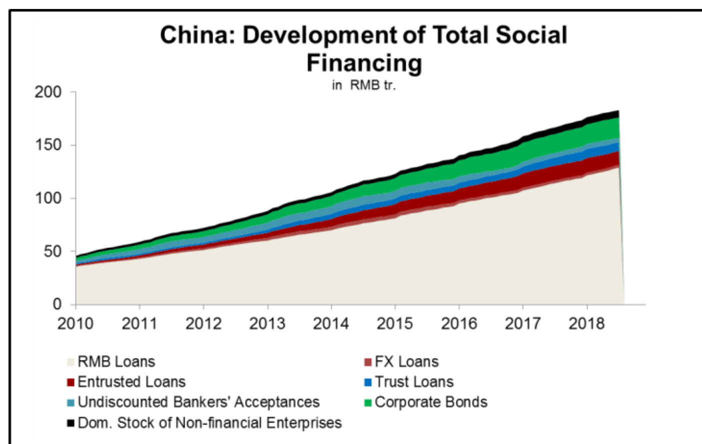
These off-balance sheet WMPs plus trust products together with so called entrusted loans (these loans are basically loans between companies, but as companies are not allowed to give loans to each other directly, banks work as middleman) are the essence of shadow banking funds. They are invested in a range of financial assets, including trust loans, corporate bonds of private SMEs, property developers, LGFVs and other “less creditworthy” entities. However, these activities have not been regulated like traditional banking. One major problem is that banks could be inadequately capitalized. While legally, banks are not resposible for WMPs they channeled to their investment arms, the public sees this fundamentally different. Thus, banks could be de facto responsible for risky assets that are much larger than the figure on their books. Secondly, given their complex network, financial intermediaries could lose track of what their real risk really is. A breakdown of one node could trigger a chain reaction, spread panic and ultimately result in a credit crunch.

Here the new regulations come into play. A lot of different aspects have been covered by authorities. Recently, the impact on the asset management business was in focus, tackling issues like implicit guarantees, duration mismatch, cash pooling, complicated structures and over-leveraging.

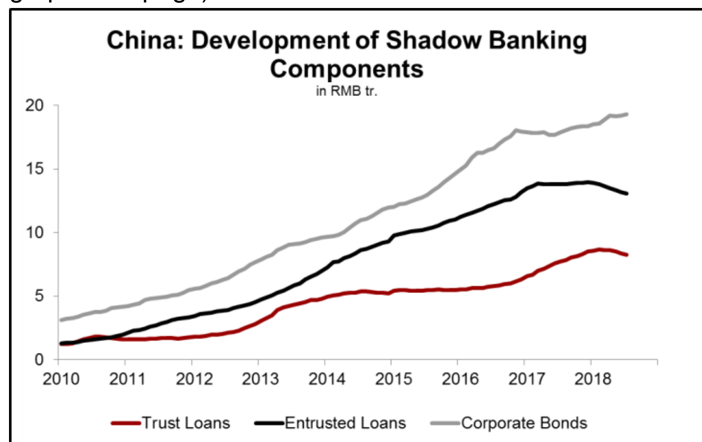
- First, the implicit bank guarantee for WMP investors is replaced by a new rule that requires WMPs to explicitly publish their net asset value (NAV).
- Second, the regulation bans cash pooling of different WMP, which had been a common practice requiring a clearer matching of WMPs and the use of funds.
- Third, it sets a maximum ceiling of four layers, i.e. the number of banks/trust/security firms to be involved between the original WMP and the final credit.
- And most importantly, WPMs are not allowed any more to invest in non-standard assets (NSAs = not traded in a standardized market) that mature later than the WMPs, addressing directly the maturity gap. Under already existing regulations, the share of investment in NSAs was already limited to 25%.

Adjustment pressures cut into credit growth

This example of regulation makes clear that the overall regulatory tightening has led to adjustment pressures, especially in terms of risk management, to convert NSAs and to put shadow products back on banks’ balance sheets. To quantify the problem, we stick to official Total Social Financing figures (TSF). They show that trust loans, entrusted loans and undiscounted bankers’ acceptances (typically also considered shadow banking) added up to RMB 27 tr by the end of 2017, or about 25% of nominal GDP. Including corporate bonds, the number rises to RMB 45 tr or 44.5% of GDP. This compares to TSF RMB (traditional bank) loans of 119 tr (144% of GDP). HSBC puts the figure of NSA in off-balance sheet WMPs to RMB 4.8 tr.

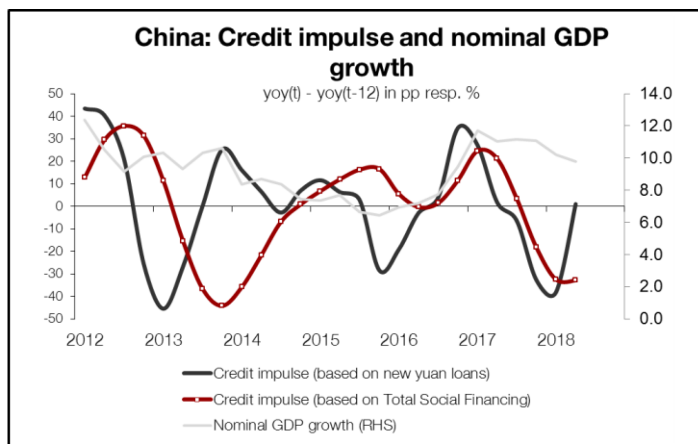


From Jan. to Jul. 2018, the level of “narrow” shadow banking credit (trust loans, entrusted loan, acceptances) receded by RMB 1.75 tr. In terms of percentages, trust loans fell so far this year by 3.5% and entrusted loans by 6.5% and banker’s acceptances by 12.3% (all Jan. to Jul. period). This also took its toll on TSF. In the first seven months of 2018, it expanded by 5.7%, falling short of the comparable figures in the last two years of 8.9% and 7.3%. In sum, TSF expansion slowed, implying a significant negative credit impulse (which is technically the second derivative of total TSF). From a macroeconomic point of view, this is often considered a warning signal of some slowing ahead, although in China, the correlation has been rather soft (see graph next page).



China’s monetary policy revisited

Against this background, it is worth reconsidering recent PBoC action. The central bank cut its Reserve Requirement Ratio (RRR) twice (mid-April by 100 bps, end June by 50 bps), both times with special provisions to support SME lending. In mid-July, the PBoC surprised markets by



unexpectedly injecting RMB 502 bn in its one-year medium-term lending (MLF) facility. To tap the MLF was reportedly skewed to lenders that have invested in bonds rated AA+ or below. In sum, measures of the PBoC appear to be well geared towards supporting sectors that risks to be most negatively affected from regulatory tightening, i.e. smaller firms and parts of the corporate bond market. The PBoC needs to prevent a domino-style credit accident. And the best the PBoC can do is to provide ample liquidity, so that regular banking loans can substitute shadow bank credit. The cuts in RRR have freed up about RMB 1.9 tr, almost matching the drop in shadow banking loans since the start of the year. In order to reach a TSF growth rate of around 13% for total 2018 (TSF growth was 13.7% in 2017 and 12.8% in 2016) the PBoC has to do even more. Given that TSF growth lags markedly behind the comparable numbers of the two previous years, TSF would need to increase by about RMB 4.5 tr to just make up for the gap that has already opened up. In terms of RRR cut, this would amount to additional 200 bps.

Markets have in part interpreted the recent PBoC action as the beginning of a stronger easing policy. However, given these figures, we interpret it more as an attempt to neutralize the credit gap that the regulatory tightening produces in the shadow banking sector. The PBoC clearly already embarked on filling this gap. New yuan loans in the official banking sector accelerated unusually strongly to 19.1% yoy ytd of late. M2 growth, which hit its lowest level on record in June with 8%, recovered to 8.5%. And while short term money market interest rates fell only temporarily, the 3-month and 6-month interbank Shibor rates broadly stabilized 150-180 bps below levels that prevailed in Q1, which we see as a (warranted) sign of ample liquidity in the interbank market.

The economic policy response

However, China is now facing the double risk of regulatory tightening and the escalating trade war. This combination creates a new policy environment. In fact, it puts China back into a long-standing dilemma: On the one hand, Beijing wants to leave behind the old approach of a debt-fueled, resource-intensive and investment-led growth. This break with the past is the very essence of two of President Xi's "Three Critical Battles" against financial risk and pollution. However, on the other hand the legitimacy of the Communist Party is very much built on providing higher living standards to the population, which makes it necessary to not let growth fall below a certain threshold level. This "comfort" level can implicitly be defined by the government promise to double real GDP within the 10 years to 2020, which makes it necessary to keep growth for the remaining years close to 6.2%.

Looking ahead, we see monetary policy much deployed with neutralizing the effects of regulatory tightening. We do not expect China to give up on this project, but to shift to a gentler pace. The PBoC will stick to its policy of "neutralizing" regulatory tightening with more liquidity injections. We expect RRR cuts by in sum 150-200 bps and further support for special market segments.

However, this also means that fiscal policy will predominantly be in charge of stabilizing growth. In fact, this is ultimately a political decision and several scenarios are feasible. In our main scenario, China will aim at protecting its 2018 growth target of 6.5%. This would be no strong demand as China's growth averaged in H1 2018 6.75%, so that technically H2 growth could weaken to 6.25%. Assuming a current expansion rate of around 6.5% in Q3 and the tariff disruption to fully impact already Q4, growth could (rough and ready) drop to 5.75%. Technically, this would imply only a fiscal policy package of the size of 0.5 pp of GDP. But credit tightening as well as including some buffer would also be warranted. In sum, a package of 1%-2% of GDP looks sufficient, but rather no "big bang". In fact, the State Council only announced a more "proactive" fiscal policy stance. It reiterated (from the NPC in March) tax cuts worth RMB 1.1 tr (1.3% of GDP) this year. On May 8 this year, the Ministry of Finance revealed a new local government bond quota of RMB 2.18 tr, an increase by 34%. This includes RMB 1.35 tr special infrastructure bonds, of which only RMB 300 bn were issued, implying spending ahead of another 1.3% of GDP. Thus, protecting the 6.5% growth target looks well within reach this year (notwithstanding negative confidence effects of a stronger cooling).

However, the question of the growth target next year is much harder to answer. Here, we rely very much on taking the reform agenda moderately seriously, i.e. policy will not aim at pushing ahead with credit-fueled investment but also not fall below its comfort zone. Thus we stick to our view of growth around 6.2%/6.3% in 2019. However, we can also not exclude a "panicking" scenario in which the government reform agenda will be postponed another time. This clearly also depends on the US-China trade war. Nevertheless, such a development would be considered a blow to Presidents Xi's reform goals.

Imprint

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