CHINA ECONOMIC UPDATE NOVEMBER 2016

Under the radar – an increasingly complex financial system is driving a change in China's monetary policy

NAB Group Economics

Since the middle of 2015, the seven-day Shanghai Interbank Offered Rate (Shibor) has been unusually stable – when compared with the extreme volatility in this market over the preceding five years. This highlights a low profile shift in the management of China's monetary policy that was necessary to control an increasingly complex, interconnected financial system.

CHINA'S INTERBANK INTEREST RATE

Volatility fell away in mid-2015

Source: CEIC, NAB Economics

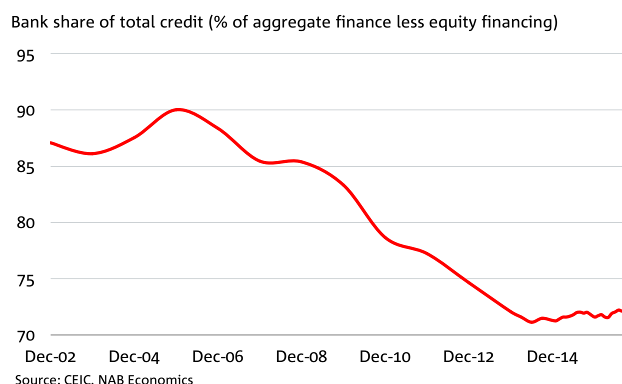
EVOLUTION OF THE FINANCIAL SYSTEM

Prior to the Global Financial Crisis, China's financial system was relatively simple. It predominantly consisted of banks engaging in basic deposit and lending operations, with regulated interest rates for both functions. These regulatory restrictions meant that there was limited competition between banks, since prices were controlled. Tight control – combined with a closed capital account – allowed authorities to maintain a system of financial repression, which depressed domestic consumption and funded the investment model of growth.

The gradual process of financial deregulation – starting with the liberalisation of lending rates in July 2013, followed by deposit rates in October 2015 – contributed to growing competition between China's banks, at a time that they were also facing greater pressure from non-bank financial institutions. This has impacted on bank profitability – the net interest margin for commercial banks declined from a peak of 2.77% in September 2012 to 2.24% in September 2016.

BANK'S SHARE OF TOTAL CREDIT

Growth in shadow banking has driven down the share of banks



Source: CEIC, NAB Economics

In particular, Chinese banks started to face increased competition for deposits. Long used to low yielding bank deposits, Chinese consumers embraced new alternatives that offered higher returns – such as short term money market mutual funds and longer term trust and bond market investment products. This contributed to the introduction of Bank Wealth Management Products (WMPs) in the latter part of last decade.

The scale of WMPs has risen considerably – up from around 1.7% of bank deposits at the end of 2008, to around 17% of deposits in mid-2016. This ratio is much higher for smaller banks – with Fitch estimating WMPs were 43% of deposits in June. WMPs allow banks to engage in off-balance sheet lending – where they generally retain the credit risk, but are subject to a lower regulatory burden – with WMPs offering lower regulatory cost (avoiding the requirements of capital adequacy and reserve requirements) and

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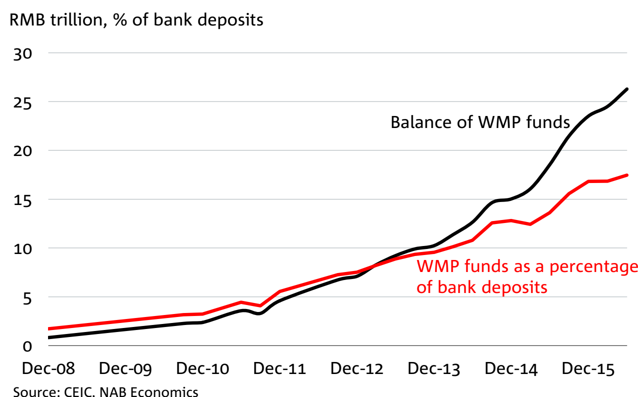
avoiding lending restrictions (such as previous mandates to limit lending to property development).

WEALTH MANAGEMENT PRODUCTS

Growing share of deposits



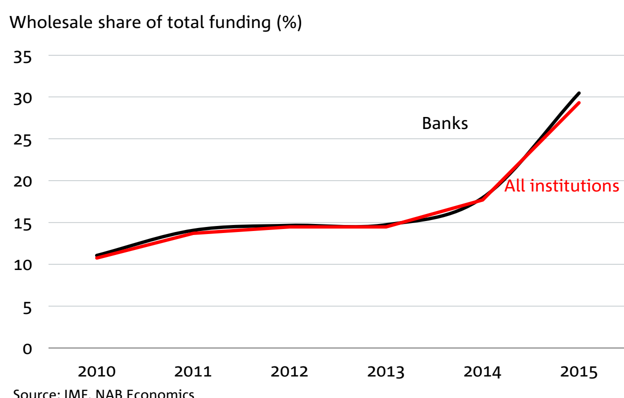
Source: CEIC, NAB Economics

In offering higher returns for savers than traditional deposits, banks similarly require higher returns on their investment. This meant that WMPs have been directed to high yielding (and often riskier) alternatives – such as bonds or shadow banking products like trust loans – increasing the interconnections between banks and non-bank financial institutions.

Bank loans have risen more rapidly than deposits in recent years, meaning that the share of bank funding from deposits has declined. Banks have increasingly relied on short term wholesale funding (largely the domestic interbank market). According to the IMF, wholesale funding provided over 30% of China's total bank funding in 2015, up from around 18% in 2014, with smaller banks particularly reliant on these sources. The short term nature of this funding is mismatched to longer term loans to corporates – adding an additional degree of risk to the financial sector.

BANK WHOLESALE FUNDING

Interbank market reliance rising



Source: IMF, NAB Economics

THE CHANGING SHAPE OF MONETARY POLICY

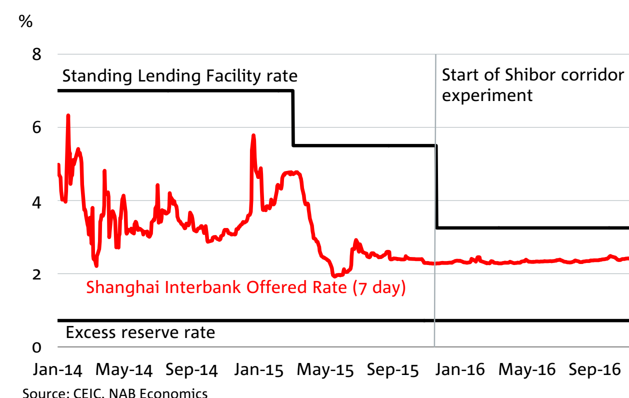
Until recently, China's monetary policy was managed on a quantity basis – controlling the growth in money supply (with an explicit growth target for M2) – rather than a price basis – such as a shorter term interbank rate (as typically used in advanced economies). Relatively few central banks globally use this method – among other issues, interbank rates under such a framework can exhibit considerable volatility, reflecting short term changes to demand for interbank funds.

In the past, where interbank funding was comparatively limited, this volatility was not a major concern. However as financial market interconnectivity has increased, volatility in interbank rates posed significant risk for the stability of the banking sector.

The People's Bank of China (PBoC) switched to an interbank rate target in mid-2015 without publicly announcing the change to markets. In a press release in November 2015 that announced a cut to the rate on the bank's standing lending facility (SLF), the PBoC briefly noted that it was experimenting with a corridor for the 7 day Shibor, with the SLF rate as the corridor ceiling and the rate for excess reserves as the floor. The PBoC has not yet identified a target for the Shibor, which along with the unannounced change in management, highlights the limited guidance from the PBoC to markets – compared with other central banks.

SHIBOR CORRIDOR

'Experiment' providing greater stability

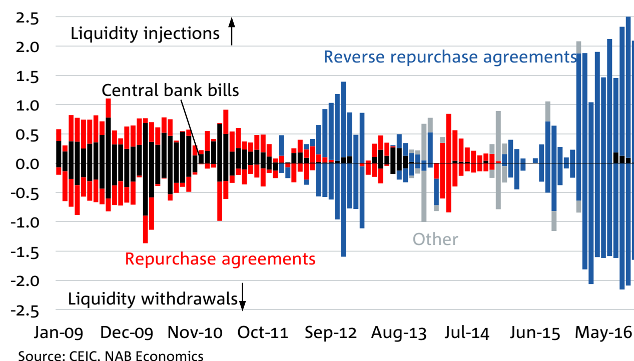


Source: CEIC, NAB Economics

The change in monetary policy management has coincided with more active (and larger volume) open market operations by the PBoC. The bank has started injecting and withdrawing greater amounts of liquidity – with a notable expansion from the start of 2016. It has also switched its used of instruments – away from central bank bills and repurchase agreements to reverse repurchase agreements – primarily seven day instruments.

OPEN MARKET OPERATIONS

PBoC more active in the market in 2016



Source: CEIC, NAB Economics

CONCLUSIONS

The switch towards a more modern approach to managing China's monetary policy is encouraging – as it provides greater funding stability for the country's increasingly interconnected banks. That said, more needs to be done – particularly around communicating policy targets (the IMF recommend using the 7 day reverse repo rate) and regulation (particularly with non-bank financial institutions).

The China Banking Regulatory Commission released draft rules in late November to tighten oversight of WMPs, including capital provisioning for these products. That said, it is not clear that these measures will be sufficient to effectively manage risk – given the blurred lines of responsibility between banks and other institutions when it comes to WMPs. The IMF argues that the increasing interconnected nature of China's financial markets means a more co-ordinated approach between regulators is required. Such a move may go some way to reducing systematic risks related to WMPs.

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