CHINA ECONOMIC UPDATE JUNE 2017

Opportunity knocks – could Moody's downgrade inspire further financial reform?

NAB Group Economics

In May, international ratings agency Moody's announced a downgrade for China's sovereign credit rating, citing the country's rising debt as a key factor in this decision. While this change generated a lot of headlines, the significance for China's economy is likely to be minimal, as relatively little of China's debt is held offshore. That said, the downgrade may inspire a renewed focus on debt management and regulation that would be a long term positive for the economy.

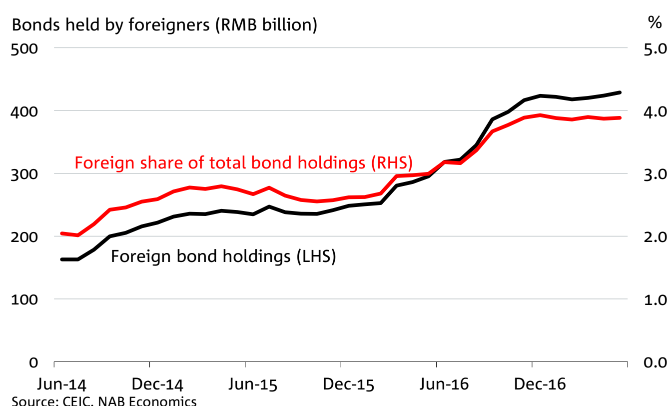
A COMPARISON OF SOVEREIGN RATINGS

Moody's cut China's overall credit rating in May to A1 (the fifth tier of the sixteen levels of investment grade) – a rating shared with Japan, the Czech Republic and Israel among others. This rating is the equivalent of the A+ rating reported by Fitch and is lower than Standard and Poor's rating of AA-.

A sovereign downgrade is typically a major concern for any economy. Investors generally demand a larger return to compensate them for higher perceived risk – leading to higher funding costs that then flow through the economy (with corporates often facing their own downgrades relative to the sovereign). However in China's case, the impact is reduced by the low level of foreign ownership of government debt. In May, foreign holdings of Chinese government bonds totalled RMB 429 billion – around 3.9% of the total. China's domestic bond investors typically pay little attention to international ratings – yields on 10 year government bonds have fallen slightly since the Moody's downgrade.

FOREIGN HOLDINGS OF CHINESE BONDS

Foreigners have a minimal share



Source: CEIC, NAB Economics

There was little surprise in Moody's downgrade – given the trends exhibited in China's financial sector and broader economy over the past few years. Moody's noted that they expect China's financial strength to decline, with debt levels increasing and potential growth slowing. The organisation also expressed concerns around the progress on economic reform – themes that we have addressed in the past.

One of the key concerns surrounding China's financial sector has been the rapid growth of shadow banking. Moody's estimates suggest that the sector expanded by around 20% in 2016 to RMB 64.5 trillion – equivalent to 89% of China's GDP. While this measure is larger than estimates based on non-bank aggregate finance (around RMB 51.6 billion or 69% of GDP in 2016), we argue that Moody's under-estimates the scale of China's shadow banking sector.

HOW BIG IS CHINA'S SHADOW BANKING SECTOR?

A shadow bank is an organisation that provides financial intermediation services without the regulatory oversight of a regular bank. From a debt perspective, the focus is on shadow bank lending – which includes areas such as trust loans, entrusted loans, banker's acceptance bills, loans by securities, finance and guarantee companies (among others), but excludes wealth management products issued by China's banks. The latter receives a lot of attention in the media – having grown from around RMB 820 million at the end of 2008 to over RMB 29 billion by the end of 2016 – but these products are a source of shadow bank funding (akin to bank deposits), rather than actual lending.

According to our estimates, China's shadow banking sector totalled 95% of China's GDP at the end of 2015, and pushed above 105% of GDP in 2016 – with some

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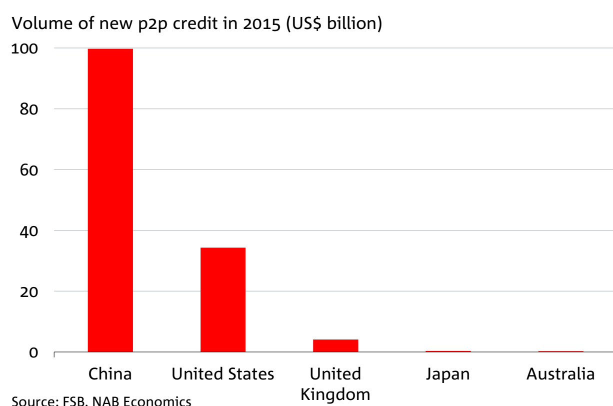
uncertainty around the exact value due to incomplete data. These estimates also exclude a rapidly growing part of the shadow banking sector – peer to peer lending (also referred to as p2p or FinTech lending) – as until recently we lacked reliable data.

WHAT IS PEER TO PEER LENDING?

Peer to peer lending is financial intermediation conducted on electronic platforms. The name refers to borrowers being matched to lenders, although in some cases a platform may pool the lenders funds together or lend from its own balance sheet. According to research by the Financial Stability Board and Bank for International Settlements, China has the world's largest peer to peer lending sector (supported by the rapid growth of internet access in recent years), followed by the United States and United Kingdom. Australia is ranked fifth overall – but lags well behind the top three markets.

P2P LENDING

China's market dwarfs other countries



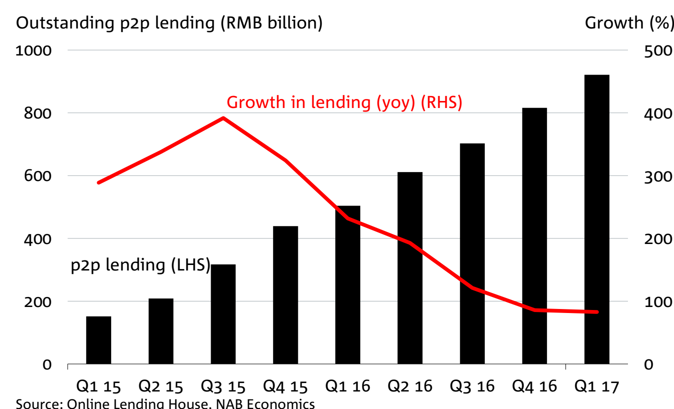
Source: FSB, NAB Economics

According to research provider Online Lending House, China's first p2p lending platform started operations in 2007, and outstanding lending totalled RMB 816 billion at the end of 2016 – equivalent to around 1.1% of GDP. It is likely to pass the RMB 1 trillion level in the next few months. While comparatively small relative to other parts of the shadow banking sector, such as trust loans, loans by securities companies and entrusted loans, p2p lending has been growing rapidly – increasing by 86% yoy in Q4 2016.

As with other parts of shadow banking, the growth in p2p lending reflects the poor access to finance for many individuals and businesses – with large state-owned banks typically preferring to lend to state-owned enterprises. In particular, p2p lenders provide smaller loans that are often unavailable elsewhere. For investors, returns have been considerably higher – with the average p2p return in 2015 around 8.5 times larger than a 6 month term deposit from a major bank and 2.5 times larger than a wealth management product (PIIE).

CHINA'S P2P LENDING HAS SURGED

Albeit accelerating off a small base



Source: Online Lending House, NAB Economics

That said, there have been significant issues in the sector in recent years, with limited supervision resulting in numerous high profile fraud cases and Ponzi schemes. In response, Chinese authorities tightened regulation over the sector in August last year – preventing platforms from accepting deposits, guaranteeing principal or interest on loans, securitising loans or financing their own projects. In addition, there are restrictions on borrowing – a maximum of RMB 1 million for individuals and RMB 5 million for companies – combined across multiple platforms and greater clarity around regulatory oversight. These measures are likely to slow the rate of growth in p2p lending over the next few years.

CONCLUSION

Moody's downgrade of China's sovereign credit rating in part reflected the rapid growth of shadow banking over the past decade. While tighter regulation and closer oversight of the sector should assist in managing its risk, further financial reforms (perhaps inspired by the downgrade) that widen conventional financial access of non-state owned enterprises and individuals would be encouraging – filling the gaps that have allowed shadow banking to flourish.

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