China Economic Update

China needs to manage the short term risk of shadow banking during financial reform

In early March, China recorded its first domestic corporate bond default when the Shanghai Chaori Solar Energy Science & Technology Company failed to make a RMB 89.8 million interest payment, having narrowly avoided a similar outcome in January 2013. It is significant that neither the central nor local governments chose to bailout the company – despite the relatively modest size of the interest payment (equivalent to around US$14.7 million) – and instead allowed the default to remind investors in the country's $1.4 trillion corporate bond market of the inherent risk of these products.

The default followed a last minute bailout of a Chinese trust in late January, when the Credit Equals Gold No.1 trust product, sold by the China Credit Trust and backed by the Industrial and Commercial Bank of China (ICBC) – China's largest bank by assets – came within days of a default that some commentators argued could have triggered a major financial crisis. Funds from the product were used to finance a loan to a coal company that failed. Instead, a deal was struck four days before maturity between ICBC, China Credit Trust, the Shanxi provincial government and a reported but unidentified buyer, which guaranteed investors the return of their principal but not all of the scheduled interest.

These two events, along with a range of similar products approaching maturity in coming months (according to Bernstein Research, more than 43% of the RMB 10.9 trillion ($1.8 trillion) worth of outstanding trust products come due in 2014), have once again highlighted the broader concerns around the country's shadow banking sector. Bank of America-Merrill Lynch have described the bond default as China's 'Bear Stearns moment' – a precursor to a broader financial crisis. In such a scenario, wary investors and bankers become more risk averse, and attempt to liquidate suddenly undesirable assets. This would also trigger a major credit crunch, which could cause further bankruptcies.

For the moment such concerns are a worse case scenario. For one thing, the scale of the Chaori default is far smaller than the Bear Stearns. Secondly, in the cases of both Bear Stearns and later Lehman Brothers, these firms were major financial intermediaries, with countless financial counterparties worldwide, which contributed to the rapid spread of contagion. Thirdly, there is misplaced belief that there is no history of default within the shadow banking sector, when in fact there have been several cases of credit trust defaults, including cases which resulted in investors losing money (albeit none for around a decade). Finally, concerns around risk in China's financial sector could increase the pace of reform, potentially a beneficial process for the economy.

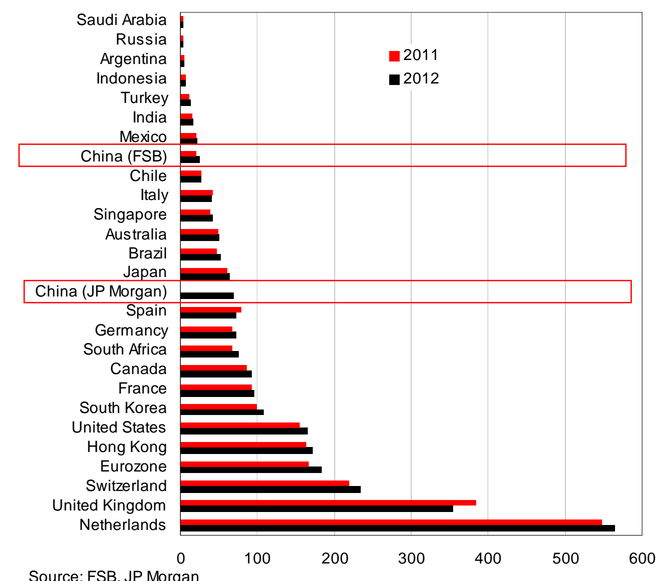
What is shadow banking?

Broadly, a shadow bank is a financial institution that provides services similar to those of a traditional bank but lacks the regulatory oversight or supervision that traditional banks receive. The term shadow bank can be problematic, as the term carries a pejorative tone, potentially implying that these activities are untoward or even illegal. In most cases, shadow banking activities are completely legal, however the lack of regulation means that tracking the characteristics of loans – such as their size, interest terms and maturity dates – and the flow of funds can be much more difficult.

Shadow banking is by no means a unique phenomenon to China. The Financial Stability Board (FSB) monitors shadow banking across 25 jurisdictions globally, covering around 80% of global GDP and 90% of global financial system assets. According to the FSB, global shadow banking assets totalled US$71 trillion at the end of 2012 (the most recent data available) – equivalent to 24% of total financial assets and 117% of global GDP.

According to the FSB, three countries have shadow banking sectors that are over twice the size of their respective economies – the Netherlands (565% of GDP), the United Kingdom (354%) and Switzerland (234%) – reflecting the considerable scale of the finance sectors in each of these economies. In the case of the Netherlands and the United States, the assets of shadow banks exceed those of the traditional banking sector.

China's shadow banking comparatively modest internationally



Source: FSB, JP Morgan

How large is China's shadow banking sector?

Estimates of the scale of China's shadow banking sector vary widely. For example, the FSB's 2013 assessment estimated the sector at around 26% of GDP at the end of 2012 (up from the organisation's previous estimate of 5% of GDP). In contrast, JP Morgan estimated China's shadow banking sector to be around 69% of GDP at the end of 2012, with strong growth in 2013 increasing this estimate to 84% of GDP in Q3 2013 (however JP Morgan note that there is potential for overlapping or double counting within their estimate). There are a broad range of other estimates, as detailed in the table below.

Credit growth outside of traditional banking has surged

	Date	RMB tn	% of GDP
JP Morgan *	Jan-14	47	84%
FSB	Nov-12	14	26%
JP Morgan	May-13	36	69%
CICC	Apr-13	27	52%
Deutsche Bank	Jan-13	20	38%
Citi Research	Jan-13	28	54%
Barclays	Dec-12	25.6	49%
GF Securities	Dec-12	30	57%
Hua Tai Securities	Dec-12	25	48%

* Estimate at Q3 2013, other estimates at end 2012

Sources: FSB, FRB San Francisco, SEI, JP Morgan

Differences in the scale of shadow banking estimates in part reflect different views around what constitutes shadow banking as well as assumptions about the size of underground lending.

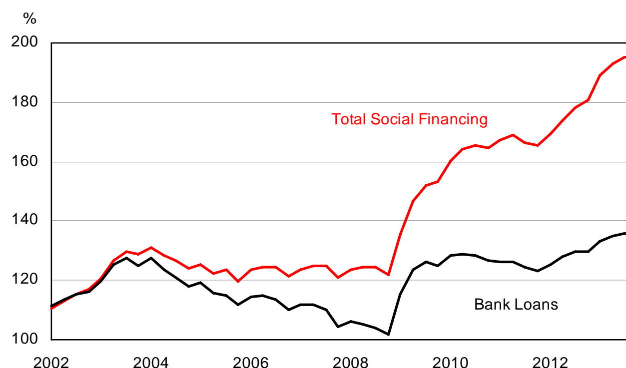
While the scale of China's shadow banking sector is not particularly concerning, particularly when compared with other major economies, the rate of growth in the sector is a concern. The Bank of International Settlements and International Monetary Fund highlight that rapid increases in credit-to-GDP ratios can be a warning sign for a country's financial system. Using JP Morgan's assessments as an example, shadow banking increased from around 48% of GDP in 2010 to 84% in Q3 2013.

Shadow banking and total social financing

Individual (and divergent) assessments of the scale of shadow banking pose some problems in attempting to track credit-to-GDP ratios over time. A similar, although not analogous, measure is Total Social Financing, produced by the People's Bank of China. This measure provides the amount of funding that the real economy receives from the financial system over time, however the data only tracks flows during each period, rather than providing the outstanding stock of debt. The common approach is to assume that non-bank funding was negligible at the start of the series (in 2002), and to scale up the stock from the quarterly flow data.

Total social financing allows us to monitor trends in credit-to-GDP ratios more easily than shadow banking assessments. If bank credit alone is considered, China's credit/GDP ratio increased from a recent low of 102% at the end of 2008 to 135% at the end of 2013. However if the broader total social financing approach is used, credit-to-GDP increased from 122% at the end of 2008 to 195% at the end of 2013.

Credit growth outside of traditional banking has surged



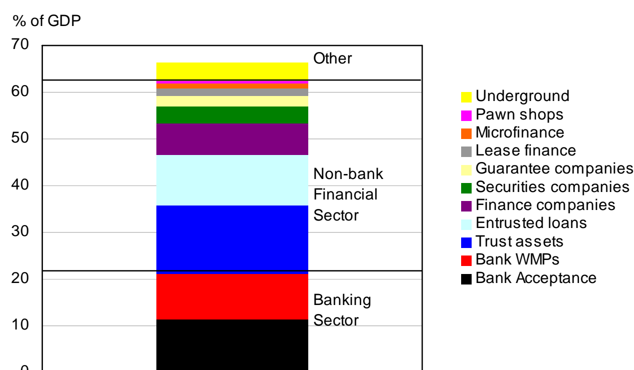
Sources: CEIC, NAB Economics

The non-bank loan component of Total Social Financing (around 61% of GDP at the end of 2013) includes elements of shadow banking, but they are not analogous. For example, trust loans are only considered in social financing if they are invested in real assets, but not if they are invested in other financial assets. According to the China Trustee Association, only around 47% of outstanding trust products fell under the former category at the end of 2013.

Total social financing also excludes some interbank assets, such as reverse repurchase agreements (which are effectively bank loans sold through interbank markets) and interbank payment services (such as domestic letters of credit) – which may be included in some (but not all assessments) of shadow banking. Unlike shadow banking, total social financing includes corporate bonds.

Finally, total social financing provides no estimate of underground lending – which combined with trust funds and wealth management products (WMPs) – could comprise a considerable share of China's shadow banking sector.

Shadow banking estimate by sector (around 66% of GDP)



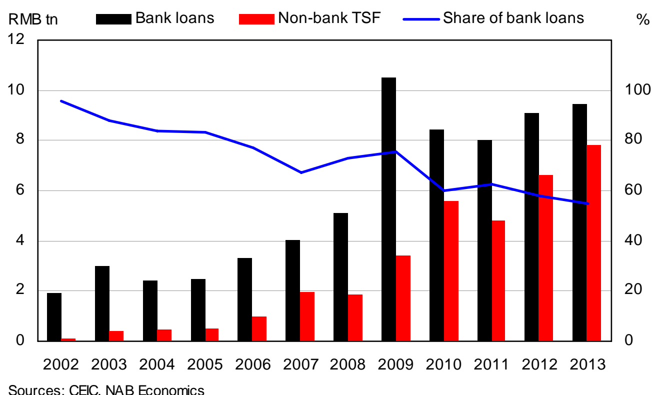
Source: Institute for International Monetary Affairs

Why has shadow banking grown so rapidly?

In part, the growth in shadow banking, as well as the non-bank component of total social financing, reflects credit rationing imposed by Chinese authorities to slow bank loans and address overheating in some sectors of the economy (such as real estate). In 2002, bank loans comprised almost all of social financing – almost 96% of the total. Following on from emergency stimulus measures following the global financial crisis, concerns around the pace of credit growth led to tightening lending requirements and regulation (such as

Required Reserve Ratio), and the share of bank loans declined – down to 55% in 2013.

Bank loan share of TSF has trended down in the past decade

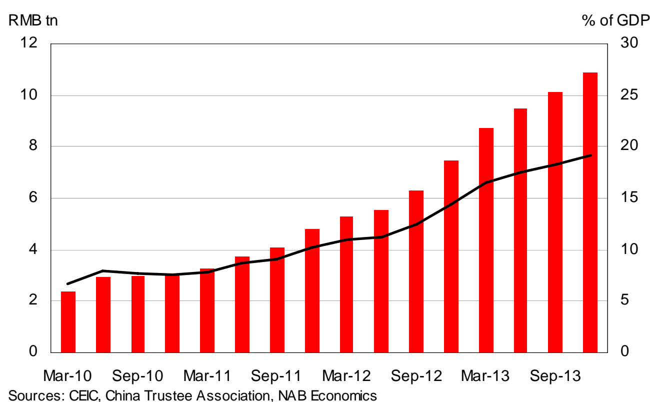


Sources: CEIC, NAB Economics

Shadow banking has provided Chinese firms access to finance that would be otherwise unavailable. This includes the small to medium enterprise sector – who face significant disadvantages in both access to and cost of finance when compared with larger state owned enterprises – and sectors like real estate (where traditional credit has been rationed to attempt to slow overheating). Similarly, trust products offered opportunities for individuals to earn higher returns than available under traditional deposits.

China's trust sector has been one of the fastest growing components of non-bank credit in recent years. Overall trust assets have risen from around RMB 2.3 trillion in the first quarter of 2010 to RMB 10.9 trillion at the end of 2013 (China Trustee Association). Trust loans typically have a relatively short maturity, on average around two years.

Strong increase in trust assets over past three years



Sources: CEIC, China Trustee Association, NAB Economics

This results in some significant issues – including a misalignment of investment horizons. According to the China Trustee Association, around a quarter of trust investment is directed towards infrastructure developments – primarily the responsibility of China's local governments. Returns from such projects have a much longer horizon than the short maturities of trusts – impacting the capacity of borrowers to service debt.

A second concern is the misalignment of risk. As banks have been responsible for marketing both trust and wealth management products to consumers in recent years, many investors assume that the products are guaranteed by the government – insuring them against losses. Despite the high yields on some of these products, bailouts for near-default trust funds have provided a view that these products are relatively low risk, raising significant moral hazard concerns.

Short term risks

In the short term, it appears that there are likely to be further default scenarios that will play out this year, however the risks associated with trust products depend in part on the sector that loans or assets are directed to. According to research by Bank of America-Merrill Lynch, around 14% of the top two hundred trust products maturing in 2014 and 2015 (by size) are directed to the coal mining industry, which the organisation considers to be the largest risk – due in part to poor profitability in the sector as a result of declining prices. Other sectors, such as property and local government financing vehicles, appear more stable – reflecting reasonable conditions in property markets in recent times and refinancing opportunities due to implicit guarantees on local government debt (assuming such guarantees continue).

Top 200 trust products* coming due in 2014 & 2015

	Number	Size (RMB tn)	% of total
Property	70	52.5	35%
LGFV	68	46.6	34%
Coal mining	27	19.5	14%
Financial	18	14.9	9%
Others	16	11.5	8%

*In terms of assets under management
Source: WIND, BofA Merril Lynch Global Research

There is also a degree of uncertainty as to who would bear the responsibility to absorb losses from a trust default – due to the role of banks in both distributing trust products and in introducing investors to trust companies.

What are Chinese authorities doing to control risks around shadow banking?

In an effort to rein in the growth and uncertainty around shadow banking, China's State Council introduced new regulations on the broad sector in early January (referred to as Document 107), including greater supervision over activities. However, there are concerns that the definition of shadow banking under the policy is too narrow – focussing on only three parts of the sector. These include: unlicensed and unregulated credit intermediaries (such as online finance companies like Alibaba, Baidu and Tencent); lightly regulated but unlicensed credit intermediaries (such as financing guarantee companies and micro-credit); and licensed but insufficiently regulated institutions (such as money market funds, asset securitisation firms and some wealth management businesses).

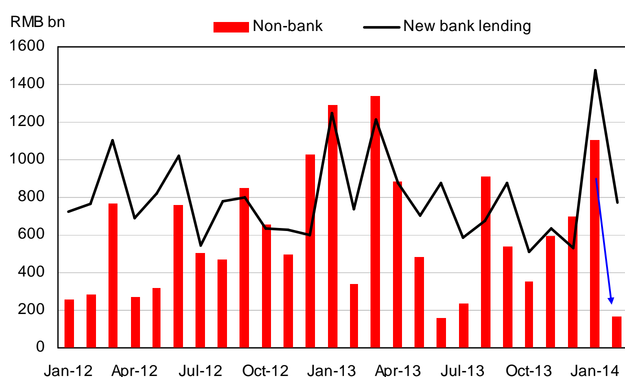
This definition is narrower than that used by the Financial Stability Board, and excludes non-banking activities of commercial banks, as well as trusts and interbank business, which the China Banking Regulatory Commission suggest are the main components of the country's shadow banking operations.

The State Council's document does not propose to drastically curtail shadow banking – noting that the sector complements the traditional banking system and provides broader investment channels for individuals – instead, citing overseas experiences during the Global Financial Crisis, it highlights the need to manage systematic risks.

The document also outlines some broader regulations for the financial sector. It requires banks to establish separate units and management systems for their wealth management businesses, while banks will not be allowed to provide guarantees for either bond or bill issuance. Trust companies will be prohibited from the operation of cash pools on 'non-standard' investments. Guarantee companies will be required to comply with existing regulations, and will be prohibited from illegal leveraging.

The impact so far appears to be a slight shift back towards traditional bank lending. In terms of total social financing data released for the first two months of 2014, there has been a spike in bank loans – with these accounting for around 64% of total social financing (well above the trend for 2013 at 55%). Some commentators have suggested that this reflects banks being forced to bring off-balance sheet items back to their books in traditional loan products.

Loans have picked up in early 2014, non-bank weak in Feb



Outlook

As noted above, further defaults are likely to occur within the broader shadow banking sector – particularly in relation to trust loans to industries with poor profitability, such as the coal sector.

Concerns of financial contagion in response to such as default are not baseless, however with careful management, they can be significantly reduced. The vast majority of shadow banking involves domestic counterparties, so the likelihood of a Chinese default spreading to global financial markets is minimal. China's banks have considerable capital reserves to meet obligations that may result from the collapse of a wealth management product or trust which they back. In addition, Chinese authorities have considerable scope to inject liquidity into financial markets. That said, should a default trigger a wave of risk aversion among Chinese investors, attempts to liquidate comparatively risky shadow banking assets could have a significant negative impact on the real economy.

An alternative, and positive outcome from this situation could be an increase in the pace of broader financial sector reform. An improved focus on both asset risk and funding allocation – away from less efficient but well connected borrowers – could contribute to a strong financial sector in future. Broadening access to corporate debt and equity funding sources would also reduce the requirements for poorly regulated and overseen shadow banking and provide a more stable platform for sustainable long term economic growth.

Recent economic data

At the start of this month's National People's Congress, Premier Li Keqiang confirmed China's growth target at 'about 7.5%' in 2014, but noted that reform was the Government's top priority. While the target is notionally unchanged from last year, comments by other government officials suggest that there could be some flexibility this year.

Finance Minister Lou Jiwei told a media briefing that job creation was a higher priority than economic growth, and that growth at around 7.2-7.3% would be in line with the target. Missing the growth target is not unprecedented, although Reuters note that the last time this occurred was 1989.

The unchanged growth target seems somewhat at odds with official targets for other measures. Economic growth targets for most provinces have been cut this year, the National Development and Reform Commission is aiming for growth in fixed asset investment of 17.5% (down from a target of 18% and actual outcome of 19.6% last year), while the Ministry of Industry and Information Technology cut the industrial production target to 9.5% (from 10% last year).

Our forecast for China's economic growth is unchanged – reflecting our expectations for softer investment and export trends in 2014, with domestic consumption unable to fill the gap. We expect growth of 7.3% in 2014 (along with 7.0% for 2015) – however the stronger growth target may indicate modest upside to this view.

Industrial Production and Investment

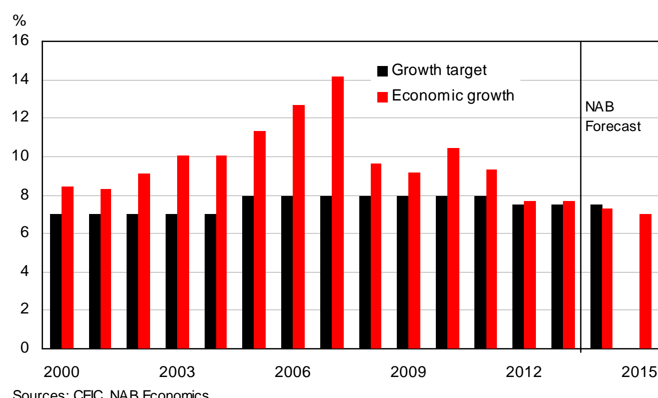
Growth in industrial production slowed significantly in February – down to 8.6% yoy (well below market expectations of 9.5%) from 9.6% yoy in December 2013. This level is the lowest recorded since May 2009 (when China was recovering from the global financial crisis). Although this result is quite soft, it may have been impacted by Chinese New Year effects (and a clearer picture of industrial conditions will emerge next month).

The downward trend in industrial production was unsurprising, given the falls in manufacturing PMIs across recent months. The official NBS PMI – which is more representative of larger state owned enterprises – eased to 50.2 points in February (from 50.5 points in January). The HSBC Markit PMI (which has a greater representation of small to medium sized manufacturers) was at 48.5 points in February (from 49.5 points previously).

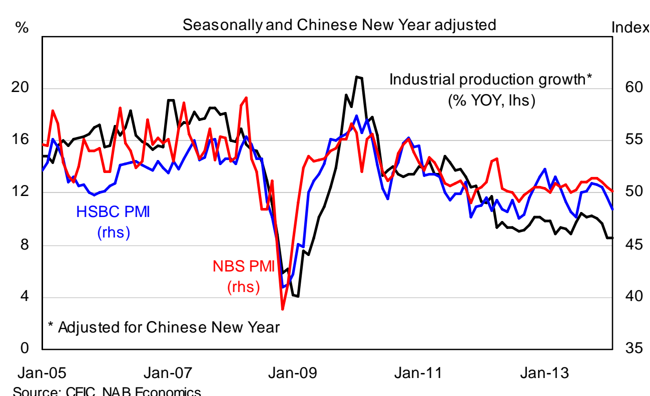
Industrial production growth slowed in most major categories. Rolled steel output rose by 4.9% yoy (down from 10.3% in December), while cement production slowed to 2.4% yoy (down from 10.8%) – with both of these sectors closely tied to the construction sector. Growth in electricity production also dipped – down to 5.5% yoy (from 8.3%), while motor vehicle production increased by 12.5% yoy (down from 23% previously).

Fixed asset investment was marginally stronger across January and February, with the seasonally adjusted rate at 17.9% yoy (up from 17.2% in December). That said, the rate of growth was still below the typical levels recorded across the past decade. Government influenced investment has slowed significantly across recent months – indicating that the effects of mid-2013's mini-stimulus program have now washed out of the system.

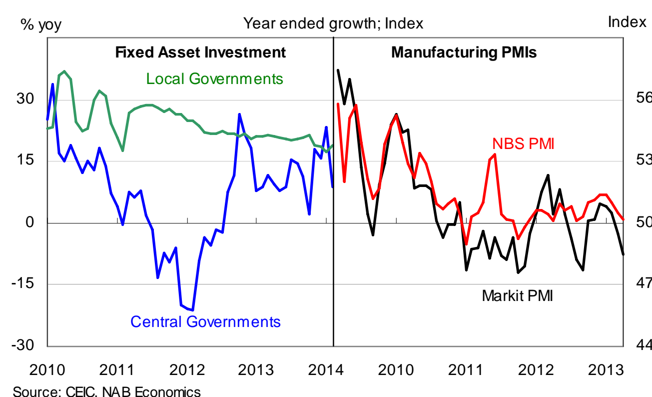
China's economic growth vs. annual growth target



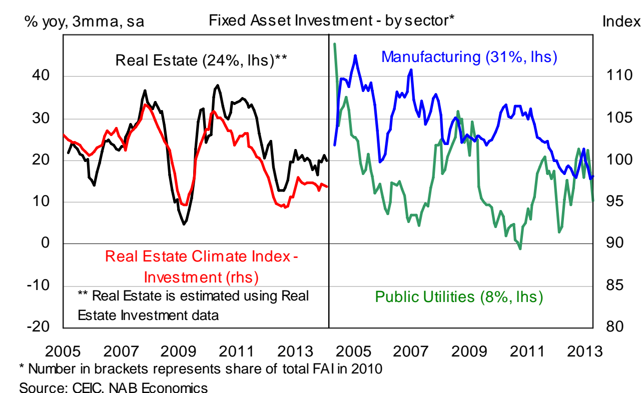
Industrial Production slows to post-GFC low



Mid-2013 mini stimulus effects now washed out of system



Fixed Asset Investment by Sector



Weaker investment levels are particularly evident in the manufacturing sector. In response to last year's stimulus, fixed asset investment in manufacturing peaked at around 23% yoy in October, but growth has declined since – down to 16% in February (on a seasonally adjusted basis). Similarly investment in public utilities (electricity, water and gas) has pulled back significantly since late 2013.

In contrast, investment in real estate has remained relatively stable – increasing by 20% yoy in February (seasonally adjusted), broadly in line with the trend levels observed across 2013. Reports from the National People's Congress suggest that Chinese authorities are currently drafting national property tax legislation, however it is unclear when it will be implemented, and what it means for pilot programs in Shanghai and Chonqing.

International trade

Trade data in February was particularly weak – which appeared to spook global markets – but this followed unexpected strong levels in January. This volatility reflects the timing of Chinese New Year (CNY).

In nominal terms, both exports and imports plunged (compared with January) – with the fall in exports particularly noticeable, resulting in a trade deficit of US$23.0 billion (compared with a surplus of US$31.9 billion in January). Smoothed across the CNY period, there was a modest surplus – equivalent to around $4 billion in both months.

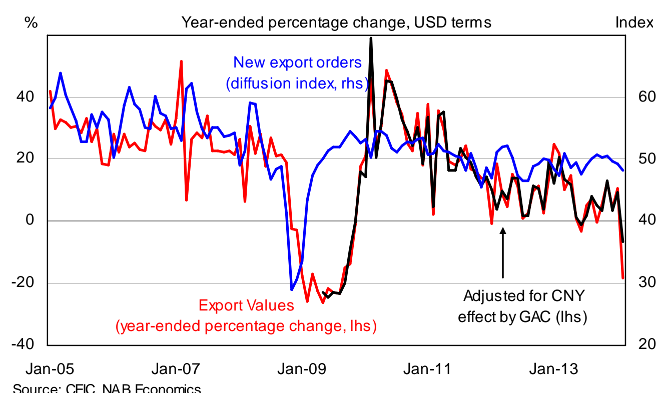
US dollar denominated merchandise exports fell by 18.1% yoy (following on from a 10.5% increase in January). When smoothed for the CNY, exports were marginally weaker over the period – down by 1.7%. This is more in line with our expectations for weak export growth in the first half of 2014 – due to crackdowns on false invoices used to avoid capital controls (a trend which artificially inflated export growth in the first half of last year).

This trend is evident in the export data by region – with a sharp slowdown in exports to East Asian markets (which fell by an average of 9.2% across January and February). This decline was driven by lower exports to Hong Kong – the main location for invoice schemes. In contrast, exports to the European Union and United States were marginally stronger – up by 4.7% and 1.3% year on year over the period.

Exports fell across all of the major categories, but most noticeably among High Tech producers. High tech exports fell by an average of 9.7% year on year across January and February (compared with -1.8% in December). Declines were more modest for Mechanical & Electrical goods (down 5.2% yoy) and Agricultural products (down 2.7% yoy).

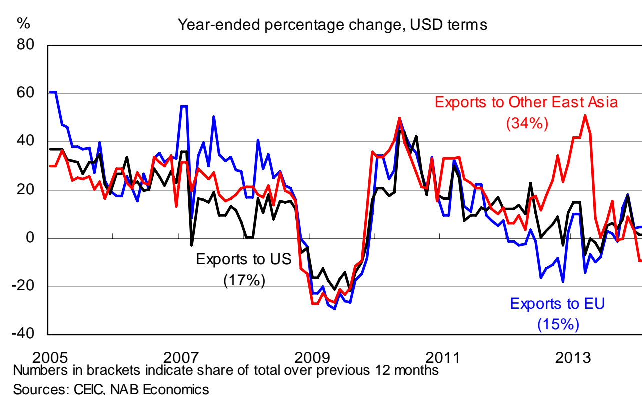
Import data also showed a sharp pullback in February (compared with unexpectedly strong results in January) – although historically February is typically a weak month for imports. When smoothed across the CNY period, average growth was relatively strong – at around 10.6% year on year (up from 8.6% yoy in December). Commodity markets were hit sharp slowdowns in February, however this once again may reflect volatility due to the new year. Over the two month period, copper imports increased by 41% yoy, iron ore increased by 21% yoy, crude oil by 11.5% yoy and coal by 9.1% yoy, with only crude oil recording slower growth than in December.

Merchandise exports and new export orders



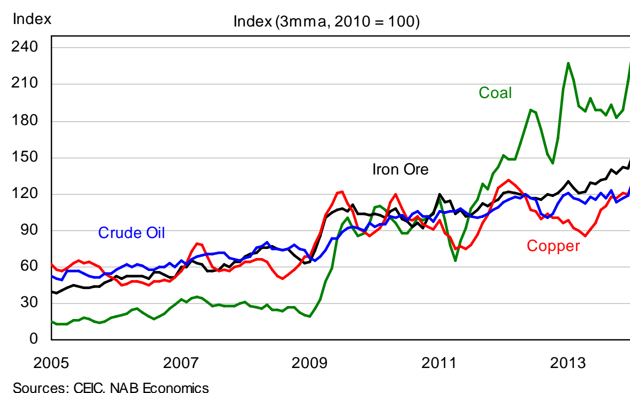
Source: CEIC, NAB Economics

Merchandise exports to major trading partners



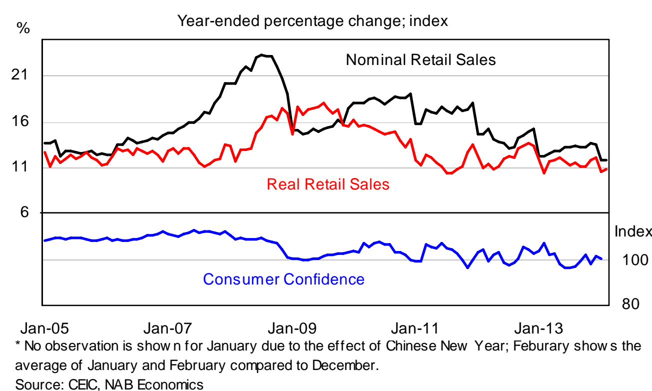
Numbers in brackets indicate share of total over previous 12 months
Sources: CEIC, NAB Economics

Commodity import volumes supported by investment



Sources: CEIC, NAB Economics

Retail sales growth slowed in February



* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.
Source: CEIC, NAB Economics

Retail Sales and Inflation

Growth in retail sales was softer than market expectations in February, at 11.8% yoy in nominal terms (down from 13.6% in December). In real terms, real sales growth was 10.9% yoy – also weaker than the levels of late 2013. Recent trends in consumer confidence have been relatively muted, and remain well below the levels recorded a year ago.

Growth rates slowed across most product categories – with food & drink retail increasing by 10.1% yoy (down from 14.8% in December), household appliances by 7.3% yoy (compared with 10.9% previously), consumer goods up by 11.8% yoy (from 13.6%) and motor vehicles sales at 11.5% yoy (down from 13.4% in December).

Headline CPI has continued to slow from the recent peak in October 2013. In February, consumer prices increased by 2.0% yoy (down from 2.5% in January). The decline was evident in both food and non-food prices – with food prices increasing by 2.7% yoy in the month (compared with 3.7% previously), while non-food edged down to 1.6% (compared with 1.9% in January). Falling prices for meat and poultry contributed to the softer food price trends.

Producer prices fell by -2.0% yoy in February (compared with -1.6% in January). The negative trend in producer prices has been evident for two years, the longest period of declines since 1999. The trend has been particularly evident in heavy industry, and closely follows US dollar denominated commodity price movements over this period.

Policy expectations

Competing policy goals may be influencing money markets at the present time. From mid-February onwards, there has been a notable downward trend in the Shanghai Interbank Offered Rate (Repo) – down from around 5.0% on 13 February to around 2.2% in mid-March – in stark contrast to a gradual increasing trend since early 2012.

The People's Bank of China (PBoC) appear to have reduced the level of weekly liquidity withdrawals in recent times – in part a likely response to the corporate bond default in early March (which immediately pushed yields on corporate and enterprise bonds higher).

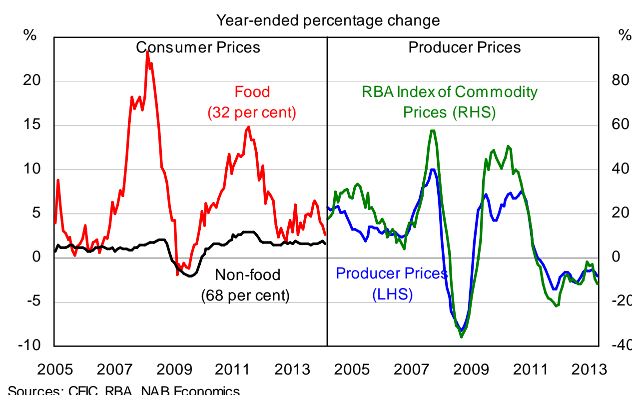
The fall is far more evident in near term rates – with more modest declines seen in three year and particularly five year rates.

Given broader concerns around unsustainable debt growth, we expect to see the Repo rate resume its upward trend, once short term concerns are cooled.

Increased liquidity may also be in response to regulatory changes connected to shadow banking. A spike in bank loans across January and February – leading to an increasing share of bank loans within the PBoC's Total Social Financing measure – likely reflects banks being forced to bring off-balance sheet items back to their books.

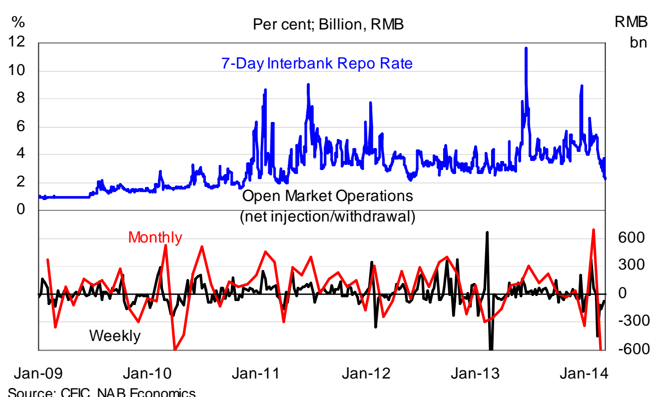
Rumours suggest that the PBoC is also considering cutting the Required Reserve Ratio – which has remained unchanged at 20% for larger banks since May 2012 – according to reports in Chinese newspaper Economic Information Daily. That said, several Chinese banks have dismissed the suggestion, demonstrating some of the uncertainty in current policy arrangements.

Consumer and Producer Prices



Sources: CEIC, RBA, NAB Economics

Liquidity conditions

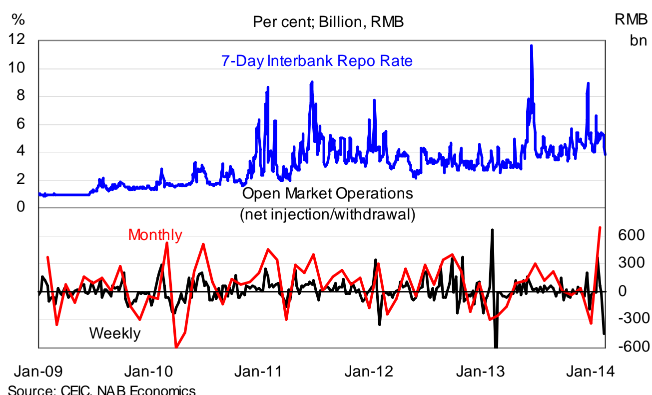


Source: CEIC, NAB Economics

Longer maturity interest rates

Sources: CEIC

Liquidity conditions



Source: CEIC, NAB Economics

On the deposit side, the Governor of the PBoC announced during the National People's Congress that deposit rates are likely to be fully liberalised in one or two years. As previously noted, the Chinese Government has signalled its intention to introduce a deposit insurance scheme prior to further reforms – reaffirming this intention at the Congress. Higher deposit rates will impact margins for major banks, but could improve funding allocation longer term.

Growth in internet based finance has played a key role in driving this reform. Rates offered by firms such as Alibaba, Baidu and Tencent are almost twice those available to traditional savers – increasing competivie pressures in the banking sector. Deposits with Alibaba's Yuebao product have reportedly increased from a few billion yuan to half a trillion yuan in the space of eight months.

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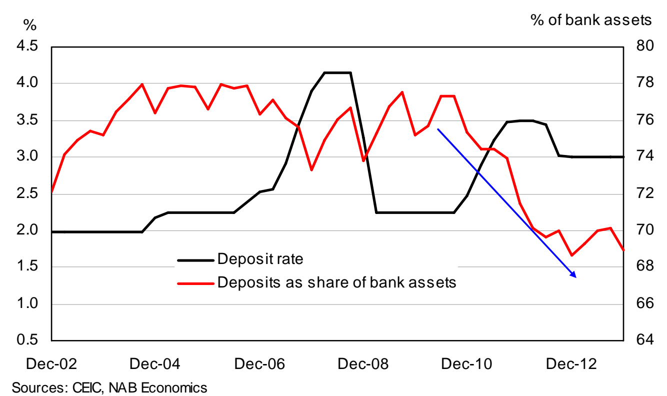
Longer maturity interest rates

Sources: CEIC

Deposits declining as share of bank assets



Sources: CEIC, NAB Economics

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