China Economic Update

by NAB Group Economics

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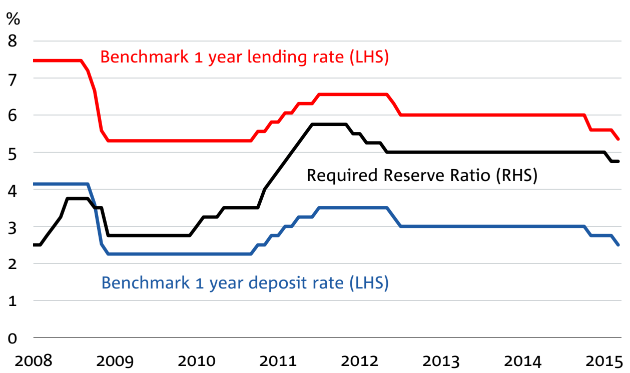
National Australia Bank

The unexpected consequences of China's crackdown on shadow banking

In early February 2015, the People's Bank of China (PBoC) cut the Reserve Requirement Ratio (RRR) – the mandated ratio of deposits banks must retain rather than lend out – by 50 basis points to 19.5% (for large institutions). This was the first broad based cut to the RRR since May 2012 and it could release around RMB 612 billion in liquidity (based on the level of deposits in January).

Monetary policy has loosened in recent months – with cuts to interest rates and the RRR



Sources: CEIC, NAB Economics

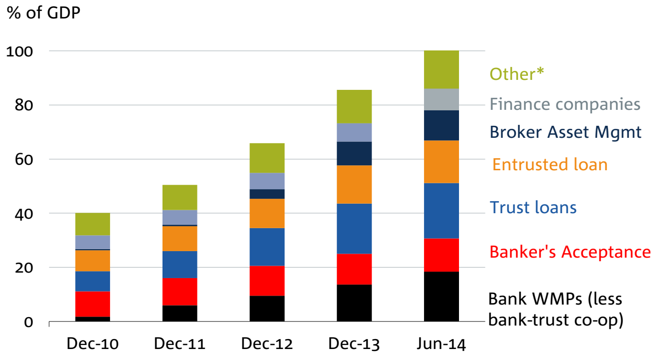
The PBoC was quick to downplay the significance of this change, arguing that the move was a response to the recent tightening in liquidity conditions and that the cut was not expected to be stimulatory. There is some basis for this argument, given the substantial outflow of capital from China in recent quarters – in part an unexpected consequence of the recent crackdown on shadow banking.

A brief update on shadow banking

We've previously taken a detailed look at China's shadow banking sector. Broadly, a shadow bank is a financial institution that provides services similar to those of a traditional bank but lacks the same regulatory oversight or supervision. In most cases, shadow banking activities are legal, however the lack of regulation means that tracking the characteristics of loans – such as their size, interest rates and maturity dates – and the flow of these funds can be much more difficult.

In our previous report, we noted that broad estimates (which may include double-counting) of shadow banking suggested the sector was around 66% of China's GDP at the end of 2012 (Institute for International Monetary Affairs) compared with far higher levels in the Netherlands (565% of GDP), the United Kingdom (354%) and Switzerland (234%) (FSB). While many advanced economies have larger shadow banking sectors than China, the rate of growth of China's sector has been concerning – given its contribution to rapid growth in debt (in excess of GDP growth).

Broad estimate of China's shadow banking sector over time – growing faster than GDP



Other comprises: Lease finance, guarantee companies, microfinace, pawn shops and underground
Source: CEIC, NAB Economics

There are a number of challenges in monitoring China's shadow banking sector. First is the inconsistent reporting of data – some is available monthly, while other is either quarterly or annual (with significant lags in the reporting of some annual data).

Second is methodology, with no firm definitions of what components are included in the sector. For example, some commentators argue that Wealth Management Products offered by banks (a rapidly growing product in recent years) are a source of funding for shadow banking, rather than being a direct source of credit for borrowers. This inconsistency contributes to a wide range of estimates of shadow banking's size.

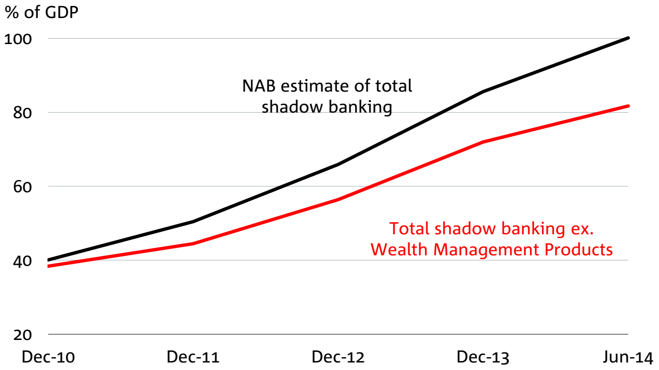
Third, evolution in the sector continues, with new products (including subsidiary asset management, insurance industry backed funds as well as asset backed securities) – with these developments occurring partly in response to tighter regulations around areas such as trusts.

Building on the methodology of the IIMA, we estimate that China's shadow banking sector grew from between 56% and 66% of GDP in December 2012 (depending on the inclusion of Wealth Management Products) to between 72% and 86% in December 2013[1]. The main contributors to the growth (excluding WMPs) were trust loans, loans from securities companies and entrusted loans.

Given available data, we estimate that the shadow banking sector continued to outpace economic growth over the first half of 2014 – despite efforts to crackdown on the sector – rising to between 82% and 100% of GDP in June 2014. However, growth in key components slowed across the second half of the year, as tighter regulation of the industry began to impact.

[1]This broad estimate may include double-counted items and may exclude more recent developments in the shadow banking sector.

Estimates of shadow banking vary according to included components – such as Wealth Management Products

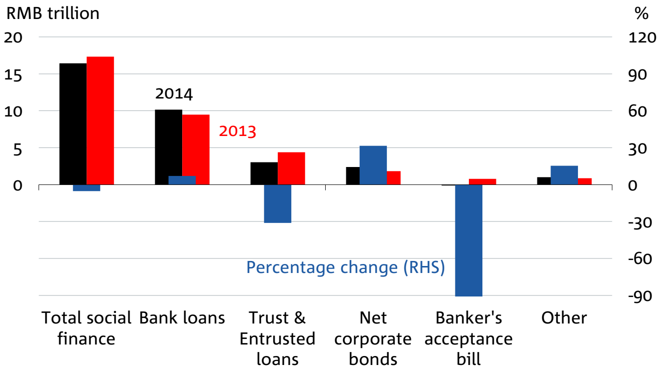


Sources: CEIC, NAB Economics

Capital outflow an unexpected consequence of the crackdown

China's crackdown on shadow banking came in response to global concerns about its rate of growth and the near defaults of trust loans to the struggling (and highly indebted) coal mining industry. Various regulatory changes across the year increased oversight over parts of the industry while limiting the volume of off-balance sheet items for banks – resulting in a sharp increase in bank loans across 2014, relative to the broad total social finance measure.

Broad new credit was weaker in 2014, with slower growth in shadow components overwhelming stronger bank loans



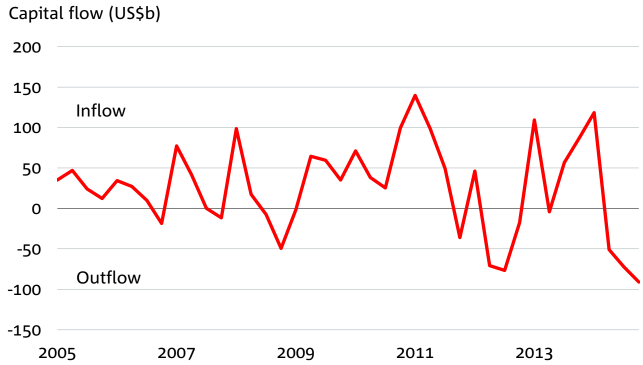
Sources: CEIC, NAB Economics

While this tighter regulatory environment may improve the stability and reduce risks in the broader financial sector, it appears to have resulted in an unexpected consequence as well – leading to a substantial outflow of capital in recent quarters.

Between April and December, there was an estimated net outflow of US$214 billion, with speculation that this represents 'hot money' leaving the country as the carry trade unwinds. The carry trade involves borrowing funds from overseas markets at relatively low interest rates and investing them in higher yielding Chinese assets (particularly in shadow banking sectors such as trusts). This trade also benefits when the Yuan appreciates over the term of the loan.

Recent policy changes have made the carry trade less favourable – the PBoC has cut the benchmark lending rate by 65 basis points since November (although the flow through into shadow banking is not transparent), while interest rates in the United States are expected to rise in 2015, as the Federal Reserve commences a long path to normalisation. Currency movements have also been unfavourable to the carry trade, with the recent depreciation of the Yuan against the US dollar.

Capital outflow has ramped up, as conditions turn against the carry trade



Source: CEIC, NAB Economics

The liquidity released by the recent cut to the RRR was little more than the level of capital outflow in the December quarter – estimated at US$91 billion or RMB 569 billion – suggesting that there is some merit to the PBoC's argument that the policy change will have minimal stimulatory effect.

Conclusion

For as long as the current interest rate and exchange rate dynamics persist, it is likely that capital will leave China – although the lack of transparency when it comes to hot money flows means that the overall stock of these funds is unknown. Further cuts to the RRR may be necessary in 2015 simply to keep financial markets liquid and functioning – vitally important to the large number of firms in China who roll over debt to continue operations.

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