ANDBANK RESEARCH

Global Economics & Markets

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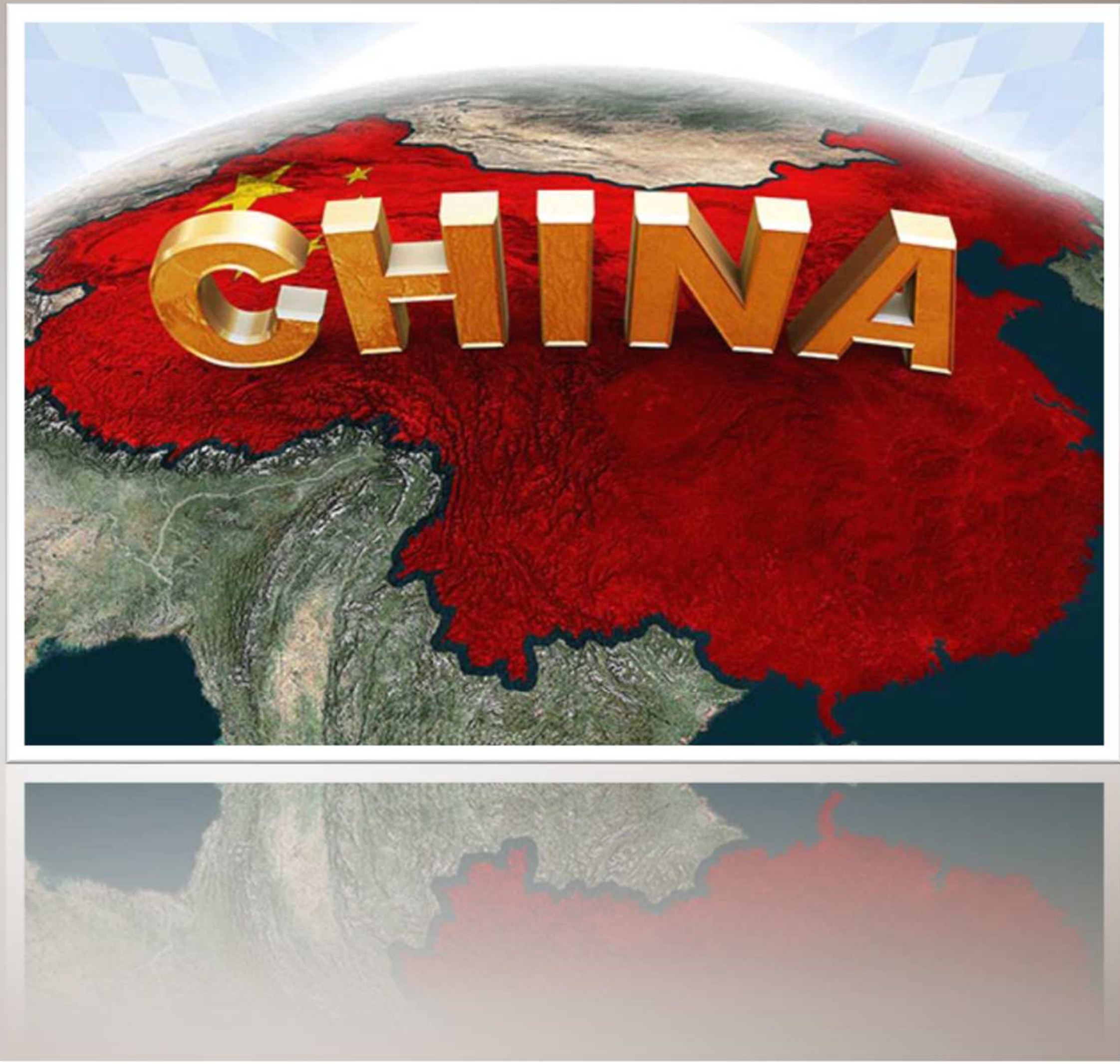

Working paper - 72

China – All that is being said about China
(and what is not said)

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Private Bankers

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The Banking System – Authorities tighten the grip

- **The government has ordered lenders to curb interbank borrowing** in the latest effort to check growth in the shadow-banking industry. Commercial bank must limit its interbank borrowing to less than a third of its liabilities, while its lending to another financial firm shouldn't exceed 50% of its Tier 1 capital.

- **NPL rise the most since 2005 in 1Q14.**
  - NPL rose 54B Yuan ($8.7B) to 646B Yuan (the highest level since September 2008).
  - The banking regulator said that Chinese bank's bad loan accounts for 1.04% of total lending at the end of March.
  - He also stressed that the capital adequacy ratio of banks fell slightly to 12.13% as of the end of Q1 (from 12.19%)
  - Trust & investment companies' NPL ratio at 0.5% or 48B Yuan (Economic Information Daily quoting data from China Jianyin Investment).
  - Individual Banks: NPL for the Industrial & Commercial Bank of China (the largest one), rose by 0.03% to 0.97% by the end of March. NPL for ABC bank grow to 1.22%. And Bank of China inched up 0.02% its NPL to 1.02%.

- **Authorities stressed that monetary easing is "no answer" to loan woes.** According to PBoC's deputy director, "liquidity is ample", with the broad money supply growing at a 12.1% pace y/y at the end of march. Additionally, he suggested that this figure underestimates actual money supply (since there are "massive" amounts of money transferred out of non-deposit-taking financial institutions, and these funds are not counted in M2).

- **Instead, PBoC warns some investment products will be allowed to fall.** Wealthy investors stage protests over trust defaults.

- **Banking system passes the stress test:** According to PBoC, the banking system can weather large increases in bad debts or a sharp economic slowdown.
  - ✓ "The asset quality and capital adequacy of China's commercial banks is relatively high".
  - ✓ "Only some individual banks would fall below the required capital ratios in a worst case scenario".
  - ✓ The test covered the 17 domestic bancs considered systemically important, and that account for 61% of total assets.

- **Big 4 banks profits surprise:** China's major banks continued to post robust profit growth in Q1 despite a slowing economy, helping them to build a buffer against a pickup in bad loans widely expected in coming years. Three of the four large state-run banks posted net profit increases of over 10%, with the Industrial & Commercial Bank of China the only one posting single-digit gains, coming in at 6.6%.

Growth Dynamics – Upbeat signs that the economy is stabilizing

Positive Dynamics

- **About the risks of a hard landing, April data offers upbeat sign that the economy is already stabilizing:**
  - ✓ Manufacturing PMI at 50.4 (up from 50.3 prior). HSBC PMI at 48.1 (up from previous 48)
  - ✓ New orders at 51.2 (up from 50.6 prior). New export orders at 49.1 (down from 50.1)
  - ✓ Services PMI at 54.8 (up from 54.5 prior). Instead, the HSBC Services PMI declined to 51.4 (from 51.9)
  - ✓ Fixed Asset Investment at +17.3% in Q1 (slowest since 2011 but still undeniably high)
  - ✓ Foreign Direct Investments +3.4% y/y in April (to $8.7bn). Up from the +1.47% y/y seen in March.
  - ✓ Loan growth at 13.7% y/y in March (down from 13.9% but still above nominal GDP).
  - ✓ M2 growth at 13.2% y/y (higher than the previous 12.1%, pointing to an acceleration in velocity of money).
  - ✓ Trade balance of April relieves pressure on Beijing**:** Exports +0.9%y/y (to EU +15.1%, US +12%). Imports +0.8% y/y.
  - ✓ Car sales jump 13% in April, although this may be due to consumers bringing forward purchases in anticipation of more cities adopting tougher regulations on ownership to fight pollution and congestion.
  - ✓ Power consumption rises 5.2% y/y in 1Q13 (with a >7% pace in March).
- **Copper premiums hit a 3-year high** as robust demand met tight local supply. This has come as a surprise since it suggests that Chinese demand in some sectors are holding up better than broader data suggests.
- **China's overall trade is likely to gain momentum** (according to statements from The Commerce Ministry): "After May, when high base effects fade off and because external trade is looking in better shape this year than previous years, trade will gain momentum". In the meantime, the Guangdong province reported a sharp drop in trade numbers during Q1 (-25% y/y), giving wings to some bear analysts to expect a grim picture for the FY 2014 (relying on the argument of a challenging increase in domestic labor costs … but without considering that increase this would probably help to develop the economy domestically).
- **China set to overtake the US as the biggest economy in terms of PPP**: According to the International Comparison Program, China was 87% of the size of that of the US already in 2011, <u>and that China is poised to overtake the US in 2015.</u>

Negative Dynamics

- **On the negative side, firms slow payments as unpaid debt weights on finances.** The median collection time for billings rose from 71 days to 90 days for first time in a decade. This has lead the "receivables" to record amounts. Nevertheless, the amount is still very narrow ($160M among the 2.300 listed firms according to Reuters).
- **Think tank cut 2014 growth forecast to 7.4% from 7.5%** (Chinese Academy of Social Sciences).

Authorities' Stance on Growth – They simply feel comfortable with a lower growth

- **"Growth in line with potential and there is no need to be negative on growth outlook".** The Deputy head at Development & Research Centers confirmed that risks still lie on the property sector and the overcapacity of some industries, but it is precisely on this topics where the government is tightening its grip.

- **China to avoid large-scale economic stimulus to boost the economy, just will stick to fine-tuning measures,** counter-cyclical in nature (and just in strategic areas). In this regard: (1)The government has just announced a raise in railway spending (to 800 bn Yuan or $128bn) in 2014, aimed at bringing 7k km of new industrial line. (2) The government has set aside 119B Yuan ($19bn) to accelerate construction in low-income housing this year. The fund will focus its efforts on cities and counties that have a large number of small companies.

- **In the same line, Premier Li Keqiang stressed that the government feels comfortable on new growth pace:**
  - ✓ "China will not relent by loosening monetary policy to calm volatile money markets".
  - ✓ "We must remain cool-minded amid slowdown".

The Stance on Reforms – Maybe slowly but reforms are broad and deep

- **On foreign Investments:** The State Council announced the following measures:
  - ✓ It will relax limits on foreign investments in listed companies.
  - ✓ It will expand quotas for capital flows (see the third point, "Reforms on Capital Account")
  - ✓ It is unveiling guidelines for cross investment in the Shanghai-Hong Kong markets (setting up a local government bond system and facilitating cross-border investment and fund raising).

  The opening up of the capital account has made investors to exit gold investments (demand for bars declined 44% in Q1), offsetting the rise in jewelry purchases (+30% y/y in Q1).

- **On Foreign Trade:** The Council highlighted that the overall Fx reserves has turned out to be a headache since total reserves have reached an all-time high of $3.95T. (US$ +130b just in Q1).
  - ✓ Premier Li Keqiang said that <u>China will take steps to reduce its trade surpluses with the rest of the world.</u>
  - ✓ At the same time, the State Council announced a series of measures to increase foreign trade (please, note that this is not to say the trade surplus). How?
    1. Clearing intermediary services and fees
    2. Expanding <u>credits to importers</u> and exporters.
    3. Greater participation of infrastructure projects in neighboring countries and <u>encouraging domestic firms to invest abroad.</u>
    4. The aim is to <u>increase two-way Yuan movements</u> allowing market forces to play a larger role in setting the exchange rate.

- **On Capital Account:** PBoC deputy governor said that Capital Account would continue being opened up slowly. Accordingly, we have seen how dollar denominated QFII stands at $54.4bn at the end of April (up from the $53.6bn in March), representing a +1.5% m/m growth or 18% y/y.

- **On Fx exchange:** Regulators announced that would ease controls on the Yuan and <u>will boost convertibility</u> under the capital account.

The Stance on Reforms – Maybe slowly but reforms are broad and deep

- **On Streamlining the over-capacity:**
  - ✓ The central government is to subsidy SMEs that must shut down operations due to overcapacity or to adapt to the stringent antipollution rules.
  - ✓ Subsidies this year will be granted to companies with overcapacity in sectors including steel, nonferrous metals, machinery and textiles. Recently, authorities have raised again the target to close outdated steel smelting capacity to 28.7M tons this year as it tries to rein in inefficient and polluting industries (last target was to close 27 tons in 2014). The overall capacity of crude steel output is 779M tons.

- **On Local government debt:** The Chairman of the Export-Import Bank of China said that local government debt is controllable and do not exceed 60% of GDP under the new legislation.

- **On environmental policy:**
  - ✓ The recent revision of the environmental law represents the first change in 25 years.
  - ✓ With this initiative, the new law will have 70 articles (while the existing law only had 47) and will come into effect on January 1, 2015.
  - ✓ Companies will face strict penalties for breaking environmental law while individuals in charge of these companies will face up to 15 years in prison.
  - ✓ The new laws sets NO limits on the fines imposed on polluters.
  - ✓ Local governments will also be held responsible if found guilty of covering up environmental breaches.
  - ✓ Why president Xi Jinping has declared war on pollution? (1) A recent official report estimated that 20% of farmland is polluted. (2) This week the government said that nearly 60% of the country's groundwater is polluted. (3) 44% of cities had "relatively poor" underground water quality and 15.7% of cities had "very poor" underground water.

- **On banking sector & Lending conditions:**
  - ✓ The Banking Regulatory Commission is working on a license system to limit banks to issue WMPs (wealth management products) based on a three tiers of licenses. Smaller lenders will likely be unable to sell these products but this measure will lead to a more prudent approach to manage risks.
  - ✓ The Regulator is also stepping-up oversight of inter-bank non-standardized debt
  - ✓ PBoC is designing a policy anchor for MM rates to limit volatility in interbank rates as well as a fraudulent fixing.
  - ✓ The PBoC is set to continue limiting lending access to developers and sectors with overcapacity, stressing that although this may slow potential growth, the overall GDP pace will remain fairly stable.

Housing Market – The government is determined to manage this risk

- **Sales fall but prices rise?** Sales fell 5% y/y in Q1 for 20 major cities, while the average new-home price rose 9.1% y/y in April (China Real State Index System). Nevertheless, this rise in price represents a deceleration for the fourth straight month. Looking at high-frequency data, prices are already declining in 45 cities in a monthly basis.

- **Fears of a bubble are on the rise:** Keeping this in mind (a drop in home sales but an increase in prices) some bear analysts point that signs have emerged that the property bubble is beginning to pop.

- **Home price declines wont become a trend!** (according to the Academy of Macroeconomic Research). This firm's conclusions are: (1) the urbanization rate is still relatively low and there is much more room for the property market to develop. (2) Declines in home prices in some cities will not develop a trend across the country.

- **Admittedly, developers are facing difficulties accessing bank loans (difficulties planned from the government)** and this will extend to 2015 as banks are said to "tighten lending further" to all industries facing overcapacity. The goal? In PBoC's words: "minimize contagion risk to the entire financial system".

- **Developers are facing difficulties also accessing the bond market:** Country Garden (a large developer) has postponed the launch of a US$ bond issue that was planned to refinance its debt. This is due to the high funding costs after the recent sell-off in a number of Chinese property bonds.

- **However, other developers denies closing down rumor.** Guang Real State Group admitted it failed to deliver some projects to homebuyers in time due to financial tightening that authorities are imposing, but pointed that still has good access to credit.

- **Developers face shrinking profits in Q1:** Data from Centaline Property showed that among 117 developers, 61 posed shrinking profits. Total net profits were 9.65B Yuan for Q1 (down 27% y/y).

- **Authorities put the focus on the Real Estate sector,** using "fine-tuning" in order to streamline dynamics in the sector: (1) Since property headwinds may be approaching top-tier cities (with sales falling in a m/m basis) <u>the Government is calling banks to speed up mortgage approvals particularly for first-time buyers</u> in order to help absorb the stock. (2) At the same time, the <u>authorities still keep its grip on the developers by restricting new credit</u>. A strategy clearly aimed at balancing the sector's capacities with the new needs.

The Currency & the Exchange Rate – Depreciation will not last long.

- **The use of Yuan gains popularity in Q1.**
  - ✓ The Bank of China cross-border settlement in Yuan soared by 71% to 1.49T Yuan.
  - ✓ The cross-border RMB index hit a record 278 points in Q1, surging by 47% y/y.

- **About the fixing of the Yuan.** The RMB fell steeply in the first quarter despite the fact that foreign capital continues to flow heavily into China according to Balance of Payments data published last Friday 9.
  - ✓ Capital Account notched up a surplus of US$ 118.3bn (within this, real money inflows –FDI- were US$ 51.2 bn and $67bn were in "hot money").
  - ✓ This means that it is the PBoC who depreciates the CNY.

- **Why the PBoC wants to depreciate?** During the 2005-2009 period, net capital inflows accounted 30% of total reserve accumulation. And in the 1st quarter of 2014, the net Capital account contributed an astonishing 90% of the increase in Reserves.

- **Who is bringing this capital into China?** Over February and March, the amount of foreign currency (USD) that Chinese exporters sold to Chinese banks was higher than China's trade surplus. This suggest two stimulating ideas:
  - ✓ The USD did not come from their normal activity (but external borrowing of USD by Chinese companies) and
  - ✓ Export companies wanted to be heavily long RMB simply because they know the RMB will be a strong currency.

- **How the PBoC is trying to curve this trend?** The instrument used by the PBoC to depreciate the CNY has been by buying large amounts of Fx (mainly US$ and Gold), specially in March. The new Yuan funds added to implement this were 174B in March. A figure that was close to the total amount outstanding in all financial institutions for foreign exchange operations.

- **Until when the PBoC will depreciate the CNY?**
  - ✓ In our humble opinion, the depreciation will not last long. Chinese corporation would apparently be reducing their borrowing activity in USD. The Chinese Academy of Social Sciences also point that the depreciation would not last long.
  - ✓ The Fx regulator has said that the Yuan "is approaching equilibrium" and that after the recent intervention (for reasons that has to do with streamlining activity of speculators) "Regulators would ease controls on the Yuan and <u>will boost convertibility"</u>.

Inflation & Markets – No surprises on the horizon.

- **Inflation:**
  - ✓ Reforms seem to be paying off in terms of lower and stable inflation (a *sine qua non* condition to the CNY to be established as a globally accepted mean of exchange).
  - ✓ This is already being reflected in a healthy and fully controlled rate of inflation (+1.8% y/y in April CPI, below the previous 2.4%).
  - ✓ The advantages of this are already being felt in the funding costs: The one-year swap rate's drop to a 10-month low of 3.63%. Monetary policy also seems to have contributed to calm money markets (with the 7-day repo rate falling to 3.14% in May 7.
  - ✓ The low CPI figure gives policymakers more room to push ahead with the needed (but not yet welcomed) reforms

- **Financial Markets:**
  - ✓ **UBS's chief China equity strategist Chen Li sees a 20% downside** for biggest China's stock on the back of a cut in profits (-3% in 2014), a weak property market expectations and a depreciating Yuan. We share the outlook for the property market but not for a depreciating Yuan.
  - ✓ **However, recently released data shows how profitability of listed firms has rebounded in 2013:** A total of 1,577 companies registered a CNY323.7bn ($52.2bn) in net profits in 2013, up 17.3% y/y.
  - ✓ In the other hand, **SOEs are beginning to off-load non-core assets under the state-backed plan** to improve efficiency in the public sector. This sale of non-strategic assets will add cash to balance sheets meaning less pressure for such companies to issue new debt.
  - ✓ **Pressure on the equity market will probably continue while the uncompetitive developers and other players in industries with overcapacity are left to bankrupt and forced out of the market (and this is not necessarily bad in the long term).**

**In our humble opinion, fears of a "hard landing" are overdone.
The current economic structure in this country seems strong enough to absorb a potential economic shock.**

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