

1 Jun 2015

The Invisible Hand of the Chinese Central Government

The Chinese central government has been driving through a series of changes in the country's financial sector, acting as the invisible hand that steers the country's growth and manages its risks. We would like to share with you a summary of these changes and our views of the potential impacts.

Recent changes to the financial sector

Reforms	Our view of the potential impact
Reduction in bank reserve requirements and 3 interest rate cuts in 6 months ^{1,2}	<p>The result from this monetary easing would be a boost to the economic growth of China, so as to maintain economic growth of around 7% annually. With a lower interest burden and greater availability of credit, it should improve corporate profitability and reduce the risk of defaults.</p> <p>Nevertheless, this would likely reduce banks' interest margins as banks' interest margins tend to get compressed during a monetary loosening cycle.</p>
<p>Implementation of bank deposit insurance on 1st May 2015³.</p> <p>Depositors will be insured for up to RMB 0.5 million, should the bank which keeps the deposits become insolvent.</p>	<p>The implementation of bank deposit insurance is a step towards liberalizing the bank deposit rates in China, and moves it towards a market-based interest rate regime.</p> <p>With this safety net in place, it is possible that some smaller banks which are uncompetitive would be allowed to fail and the government may also selectively allow certain corporate loans to default. This is to introduce the concept of risk to the capital markets as the country moves to a market-based economy.</p> <p>Nevertheless, we think there is no cause for alarm as the defaults are likely to be well controlled as it is in the country's interest to ensure stability in the financial markets and China has a huge reserve to ensure the financial sector stays well in control.</p>

Reforms	Our view of the potential impact
<p>Debt-for-bonds swap. This allows the local government to convert their bank loans (with interest above 7%pa) to municipal bonds (with interest of below 4%pa⁴).</p>	<p>The greatest beneficiaries of this move are the local governments as their debt servicing cost is almost halved and the maturities of their debt lengthened from 1-2 years to more than 5 years, on average.</p> <p>The banks could use these municipal bonds as collateral to get more funds from the Central bank. This would increase their ability to lend.</p> <p>We believe this will boost overall lending to the economy and the majority of this new lending should be channeled to the private sector, rather than the local governments, as the governments can now raise municipal bonds for their funding needs.</p>

Conclusion

The recent moves prove that the Chinese government still has ample tools to manage the growth and risks in the Chinese economy. This is largely because the economy is centrally directed and the country has huge foreign reserves. China's debt to reserve ratio is still low at about 1.25 times (the U.S. debt to reserve ratio is 150 times!)^{5,6}.

Central government – The central government is taking on the risks of bad debts from the local governments. However, given the large reserves the central government has, it should manage this risk well.

Local government – The local governments should heave a sigh of relief as their debts' maturity is lengthened and interest rate reduced greatly. However, given the poor record of capital allocation over the past several years, it is likely that the capital allocated to the local governments should moderate in the years ahead.

Private enterprises – We believe this sector will be where capital and credit will flow as banks find themselves with additional liquidity and one of their key borrowers (the local governments) now need less bank financing.

Banks – We believe the banks will find their interest margin squeezed due to the monetary loosening, interest rate liberalization and the debts-for-bonds swap. Non-performing loans should improve due to the overall reduction of credit risk with the central government actions as described above. Their share price valuation should improve with reduced credit risks and greater transparency in the debt situation.

In all, we like what we are seeing in the Chinese economy and we believe it should continue to perform well this year, barring unforeseen circumstances. We expect some choppiness in the Chinese stock market as some of the retail investor fever within China is deflated.

1 – China Steps Up Economy Help With Reduced Bank Reserve Ratios

<http://www.bloomberg.com>

2 – China Adds Stimulus With Third Interest-Rate Cut in 6 Months

<http://www.bloomberg.com>

3 – China: Deposit insurance scheme starts today

<http://www.asiainsurancereview.com/News/View-NewsLetter-Article?id=32657&Type=eDaily>

4 – China imposes \$160bn municipal bonds for debt swap

<http://www.ft.com>

5 – Trading Economics

<http://www.tradingeconomics.com>

6 – World Debt clock

<http://www.nationaldebtclocks.org>

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