ECONOMIC ANALYSIS

China | PBoC announces launch of new macro-prudential assessment system to curb risks

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On Tuesday December 29, The People's Bank of China (**PBoC) announced that it would introduce a new "upgraded" mechanism to address macro-prudential risks in the financial system, starting from 2016**. The new Macro-Prudential Assessment System (MPA) will replace the previous mechanism, which had been in place since 2011.

Formerly, the PBoC controlled risks in the banking system by setting up dynamic reserve requirement ratios (RRR) and credit quotas, used to manage the rate at which different depository institutions could issue credit loans (Figure 1). In contrast, **the new MPA will enable the PBoC to evaluate a broader range of credit products and other factors, including banks' capital adequacy and leverage ratios, asset and liability ratios, liquidity, pricing of interest rates, asset quality and foreign debt risk**s, in addition to managing loan growth.

We believe that **the move may be a response to the lack of coordination amongst regulators**, as evidenced by the mid-year stock market selloff and subsequent heavy-handed measures to curb the crash. Another example can be seen in August's surprise devaluation of the renminbi, which resulted in the government having to expend billions of foreign reserves to defend the currency.

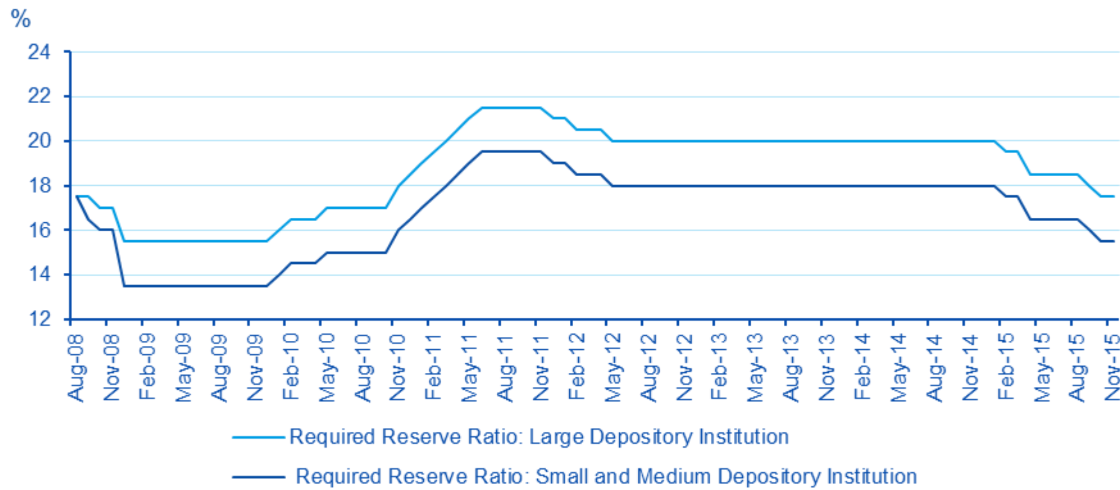
What does this mean? **The MPA will strengthen the PBoC's supervision of the entire financial system** in order to "improve the macro-prudential policy framework, more effectively guard against systemic risks, play a counter-cyclical role and adapt to a growing trend of asset diversification". **While capital adequacy ratios will remain at the core of the MPA, the new system will also target qualitative aspects of asset allocation.** Capital adequacy ratios had previously fallen solidly under the jurisdiction of China Banking Regulatory Commission (CBRC), while the power to regulate the securities market fell under the China Securities Regulation Commission (CSRC). This could be good news for financial reforms in China, as **PBoC has traditionally been a stronger proponent for reforms compared to CBRC and CSRC**.

Finally, the introduction of the MPA, starting from 2016, coincides with the beginning of the 13th Five-Year Plan. Unveiled earlier this year, **the 13th Five Year Plan proposal has vowed to reinforce macro-prudential financial management systems, strengthen coordination amongst financial regulators and improve the financial regulatory framework.** The MPA constitutes a step in the right direction, in addition to fitting in nicely with China's push for universal banking reforms.

Interest rate liberalization has taken foot strongly in China, shrinking margins at a time of domestic economic uncertainty. This has driven financial institutions to seek sources of income elsewhere, with investment banking and wealth management as key focal points. Whereas China enforces a Glass-Steagall style separation between commercial and investment banks, CBRC has floated the idea that it is considering issuing brokerage licenses to commercial banks in the last months. As the financial sector in China matures and becomes more interconnected, **a strong regulator will be needed in order to manage the seemingly insurmountable task of limiting short term volatility while simultaneously pushing forward financial deregulation.**

Looking forward, we anticipate that the PBOC to maintain a prudent monetary policy, aimed at providing adequate liquidity to counterbalance the risks of an impending slowdown. More interest rate cuts are unlikely, as this could trigger further capital outflows. However, we don't exclude the possibility of another four RRR cuts (equivalent to 200 bps) in 2016. **We expect fiscal policy to be revved up instead, with the budget deficit ratio for 2016 rising to 3.5%, with a strong upward bias**.

Figure 1
China RRR



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