4. Financial vulnerabilities persist

Domestically, risks from financial vulnerability still persist, mainly including debt overhang in the corporate sector and rampant shadow banking activities. Although the shift of the monetary stance and newly deployed regulatory efforts have somewhat slowed their momentum, the gigantic “stock” of these frailties still poses a material threat to the country’s financial stability. On the other hand, the ongoing deleveraging in the real economy and financial sector, with its original intention of mitigating the above risks, might drag on growth as well. Altogether, the authorities need to find a balance and choose an appropriate pace between pushing forward the deleveraging progress and maintaining a sustainable growth momentum.

In terms of the corporate debt problem, the soft budget constraint with the implicit guarantee from the government makes the SOEs continue their borrowing from the state-owned banks. Investment efficiency has fallen, evidenced by the over-capacity in some typical sectors. At the micro level, corporate data show that the financial performance of corporates has deteriorated steadily, lowering the asset quality of financial institutions. The corporate debt problem and ultimately the SOE reform should be addressed urgently with a comprehensive strategy, such as proactively recognising losses in the financial system, burden sharing, corporate restructuring and governance reform, hardening budget constraints, and facilitating market entry.

In addition, the surge in shadow banking is impairing China’s debt problem and posing additional risks to the financial sector, as the credit boom has been driven in part by shadow banking finance products used to funnel credit to local governments and businesses that have difficulties in getting regular bank loans. At the current stage, the financial intermediate chain, which indicates the time taken from the capital providers to the ultimate users, has been lengthening over time, suggesting an increasingly sophisticated structure of shadow banking activities. Thus, as these off-balance sheet activities are not subject to banking regulations, any collapse from the final investment destination of shadow banking, such as housing, non-standard credit assets (NSCA), bond, derivatives and money market instruments etc., will lead to systematic risks for the financial sector.

On the other hand, as the authorities have already expressed their concers on debt overhang and shadow banking, a series of measures to curb the above risks have been implemented. However, the market is also worried about the extent to which these tightening measures in the real economy and the financial sector might drag on growth in the medium and long run. For instance, M2 growth, due to the tightening measures, decreased to a historical low for the past twenty years in June.

External shocks come mainly from Fed’s interest rate hikes and Trump’s trade protectionism. In addition, populism in Europe is also adding uncertainty to the economic outlook. As the US normalisation of monetary policy is on the way, we predict the RMB depreciation and capital outflow will continue in the medium term, also in view of the continuing economic slowdown in China. Moreover, the US-centric trade policies of the new US administration will also deteriorate China’s external demand, hence the recent idea of depending on external demand to stimulate growth might not be realistic.

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