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**BBVA** Research

# Detecting China's Financial Vulnerabilities

## 1Q18

May 2018

Creating Opportunities

# Main Takeaways

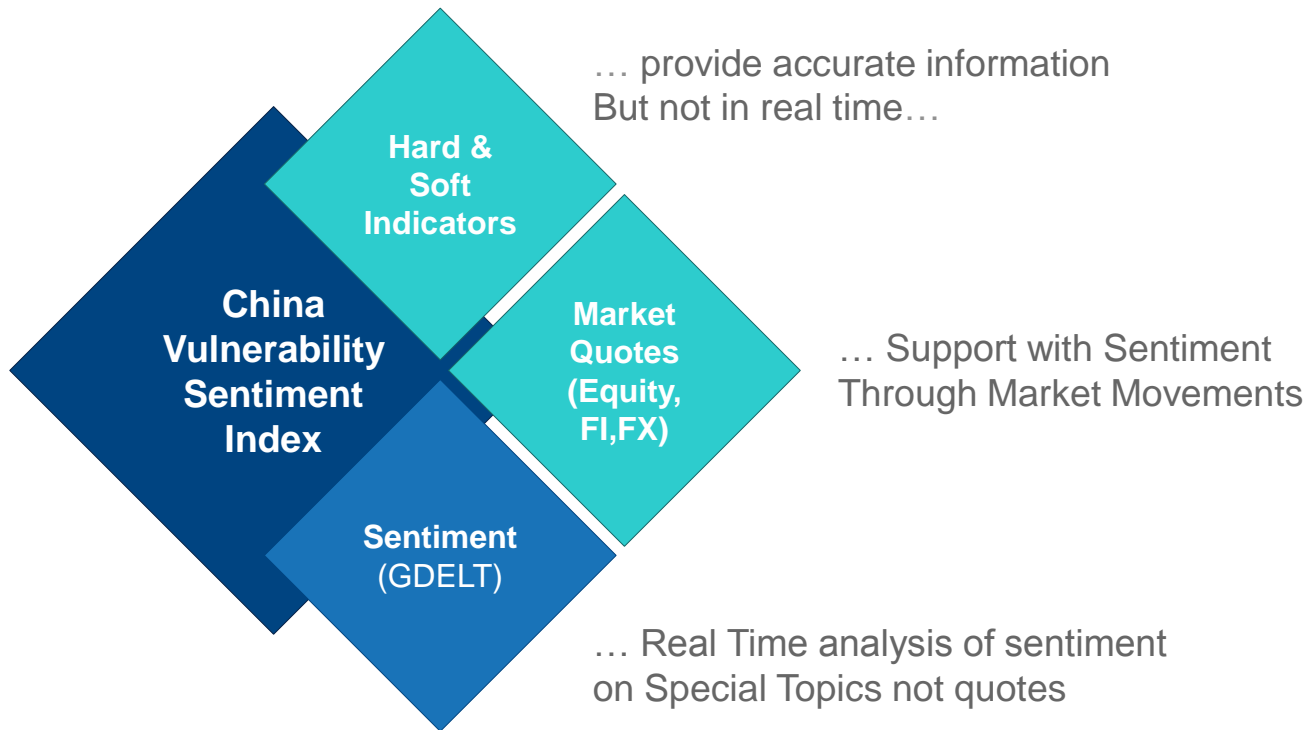
- On the backdrop of a solid growth in Q1 (6.8% y/y), the China Vulnerability Sentiment Index (CVSI) broadly remained stable despite the new emerging risk of Sino-US trade tensions
- By component, the SOE Vulnerability index rallied after the Chinese government's "two sessions". Meanwhile, SOEs' profitability continued to outperform their POE peers
- Housing Bubble Vulnerability index deteriorated as property prices remained resilient in many cities. But the index was still in a positive territory
- Shadow banking Vulnerability index held well, driven by the government's stepped-up efforts to facilitate financial deleveraging and curb shadow banking activities
- Exchange Rate Vulnerability Index dropped into a negative territory because of the RMB's faster-than-expected appreciation in the first quarter of the year



# 01

## The China Vulnerability Sentiment index

# Tracking China Vulnerability in Real Time: Value Added through Big Data



# A Balanced set of Information in the Database: Hard Data, Markets and Sentiment

## Chinese Vulnerability Sentiment Index (CVSI): components and evolution

### China Vulnerability Sentiment Index (CVSI)

<b>SOE Vulnerability Index (SOEI)</b>	<b>Housing Bubble Vulnerability Index (HBI)</b>	<b>Shadow banking Vulnerability Index (SBI)</b>	<b>FX Speculative Pressure Index (FXI)</b>
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Principal Components Analysis on each component Tone

#### Hard & Financial data

Total.profits (M) Liabilities (M)  <b>25%</b>	Mortgages.loan (M) GICS.Housing.Index (M) Housing.Price (M) New.Construction (M) RealEst.Invest (M)  <b>45%</b>	NPL.Ratio (M) TSF.Aggregate.New Increase (M) Entrusted.Loans (M) Wenzhou.Index (D) WMPs Acceptances (M)  <b>35%</b>	Foreign.Reserves (D) CNY Exchange Rate (D) CNH Exchange Rate (D) HICNHON.Index (D)  <b>40%</b>
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#### Real time sentiment indicators

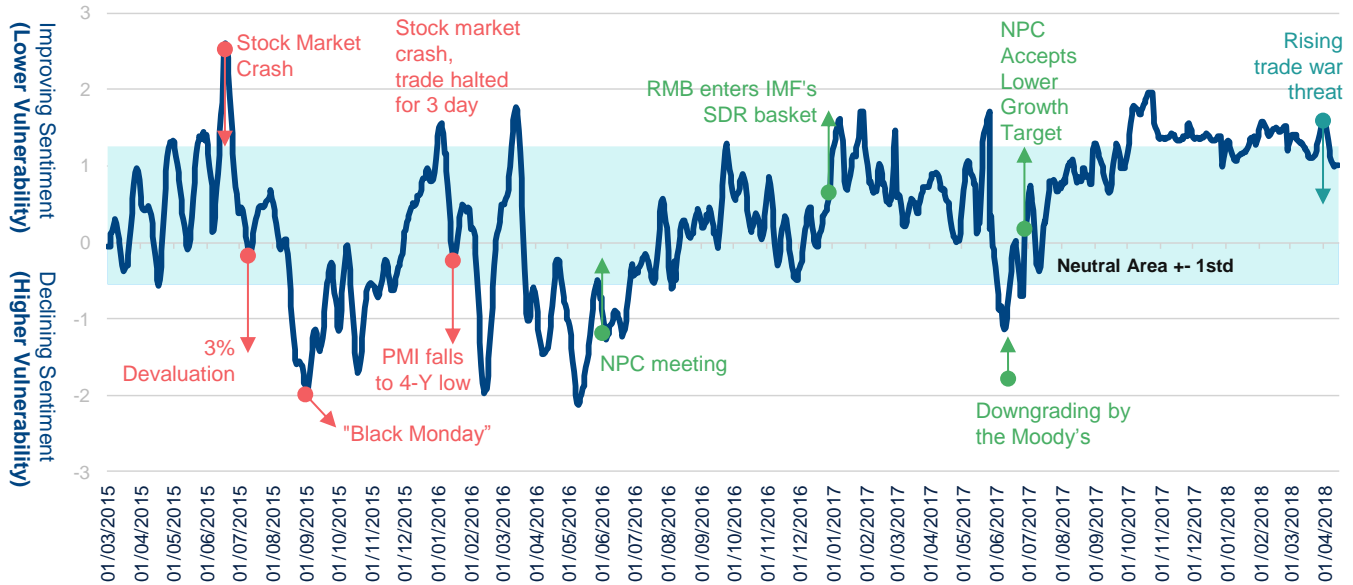
State owned enterprises (D) Resource misallocs & policy Failure (D) Resource misallocs&SOEs (D) Institutional reform & SOEs (D) Industry policy (D) Industry laws and regulations (D) Local government and SOEs (D) Debt and SOEs (D)  <b>75%</b>	Housing policy & institutions (D) Housing markets (D) Housing prices (D) Housing construction (D) Housing finance (D) Land reform (D)  <b>55%</b>	Non bank financial institutions (D) Asset management (D) Bank capital adequacy (D) Financial sector instability (D) Banking regulation (D) Infrastructure funds (D) Financial vulnerability & risks (D) Monetary & financial stability (D) State financial institutions (D)  <b>65%</b>	Currency exchange rate (D) Currency reserves (D) Capital account (D) Macroprudential policy (D) Exchange rate policy (D) Illicit financial flows (D)  <b>60%</b>
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# The index shows that Vulnerability sentiment has deteriorated as new risks emerge from US protectionism

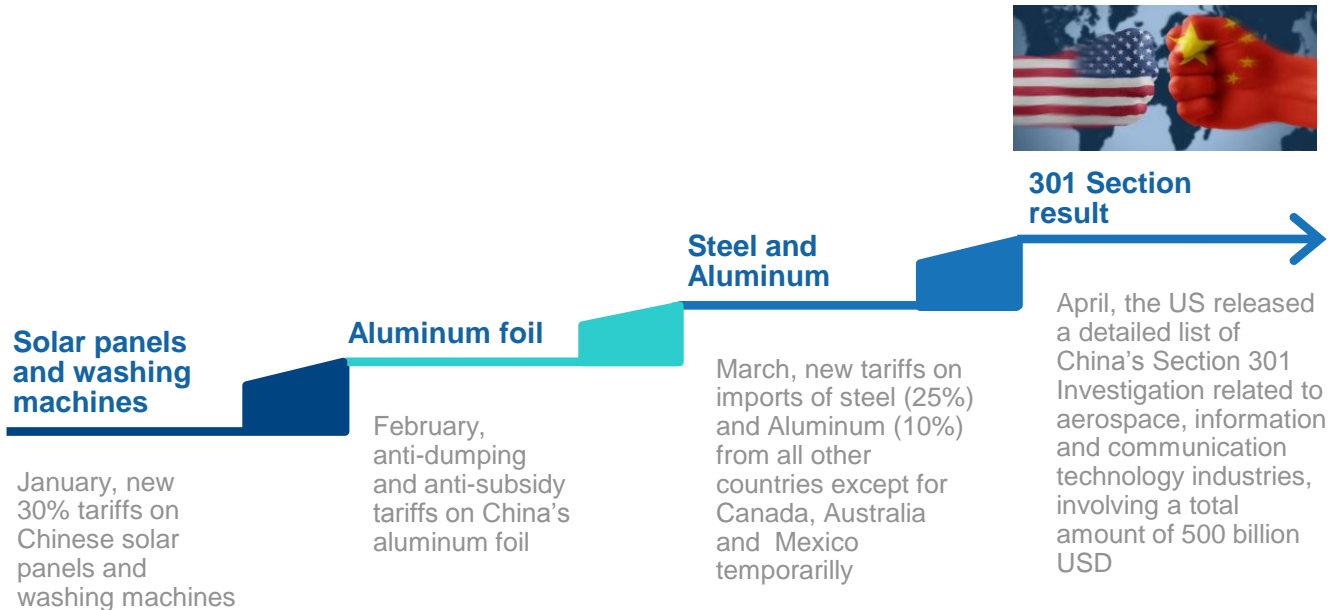
## Chinese Vulnerability Sentiment Index

(CVSI) (Evolution of the “Tone” of main followed themes about vulnerability in China.

Lower values indicate a deterioration of sentiment and higher vulnerability)



# A new risk emerged: rising trade-tension with the US



The deterioration in US-China relations is driven by deep-seated concerns among American trade and national security officials that the US is at risk of losing its technological superiority because of China's unfair trade practices and massive subsidies for domestic firms

# China's retaliation responses have both sticks and carrots

## **Sticks:** Impose tariffs on US agricultural and steel exports

- China is mulling tariffs on about \$3 billion of US exports to China, a total of about 128 U.S. products, particularly targeting US agricultural and steel exports
- Imposing 25% tariff on US pork exports and 15% tariffs on US steel pipes, fruit and wine
- China has announced a 25% tariff on \$50 billion worth of goods from the United States, including soybeans, cars, chemicals and aircrafts, with conditional implementation based on the next steps by the US

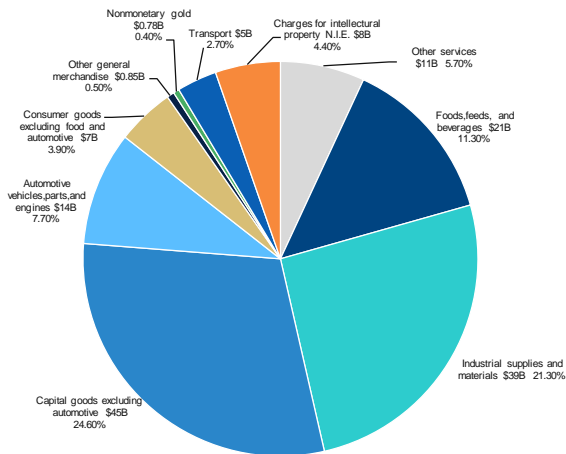
## **Carrots:** Opening-up policies in the financial sector

- Remove the foreign ownership cap for banks. Lift the foreign ownership cap to 51% for securities companies
- No longer require jointly-funded securities companies to have at least one local securities company as a shareholder
- Increase the daily quota for Shanghai-bound and Shenzhen-bound investments
- Encourage foreign ownership in trusts, financial leasing, auto finance, currency brokerage and consumer finance



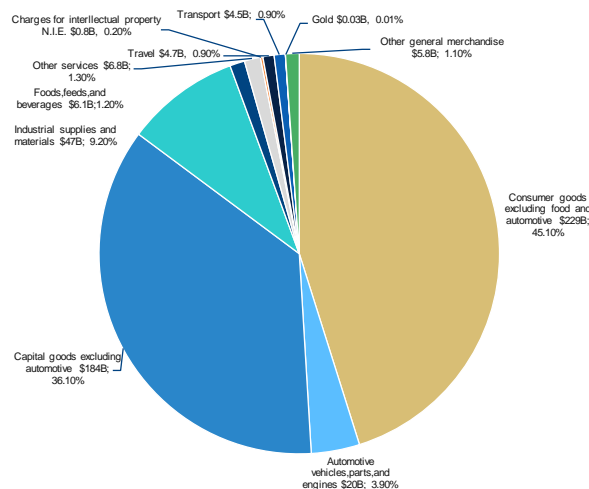
# China's retaliatory response to US's planned tariff package has so far been measured

**US exports of goods and services to China in share of total exports**  
(\$183 billion in 2017)



Source: Haver & BBVA Research

**US imports of goods and services from China in share of total exports**  
(\$508 billion in 2017)



Source: Haver & BBVA Research

China's retaliatory response to US's planned tariffs has so far been measured as these products constitute a modest share of trade from the US

# NPC and CPPC-China shift to the strong-man leadership model

## Removal of the two-term limit for the presidency

- Pave the way for President Xi to remain in office beyond 2023
- China is now entering into a new era of strongman from the previous regime of collective leadership
- Neutral for economic growth

## Restructuring government agencies

- Streamline the government and cut red tape
- Important changes include: a anti-corruption agency; weaken the role of NDRC; reshuffle of its financial regulatory regime to consolidate CBRC and CIRC etc.
- Positive for medium-growth

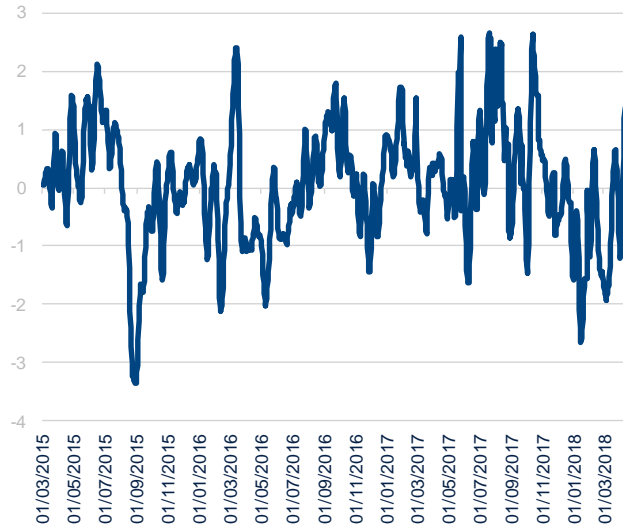
Generally, the “Two Sessions” (NPC and CPPC) are positive for news media sentiment



# 02

## The SOE Index

# Chinese SOE Vulnerability Index recent development



Source: [www.gdelt.org](http://www.gdelt.org) & BBVA Research



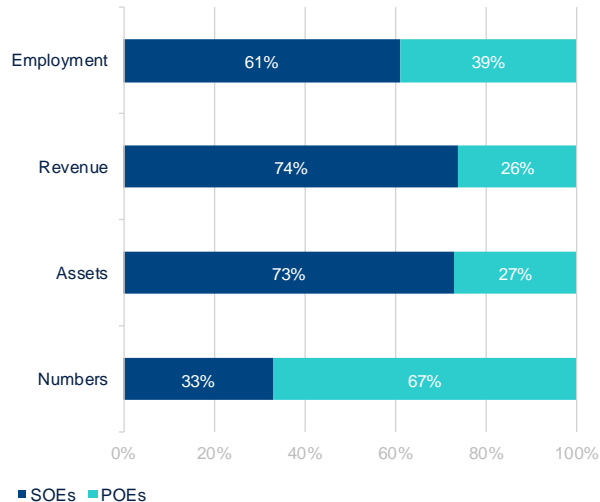
**SOE Vulnerability  
index rallied after the  
two sessions and  
better-than-expected  
financial reports**

**English Media have  
become more  
“optimistic”**



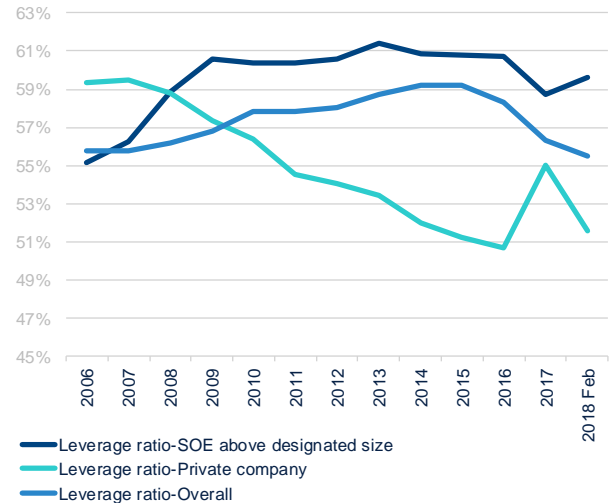
# SOEs still account for a lion's share of corporate sector

## SOEs tend to be bigger and more important among listed firms



Source: Wind & BBVA Research

## Leverage ratio in SOE rebounded

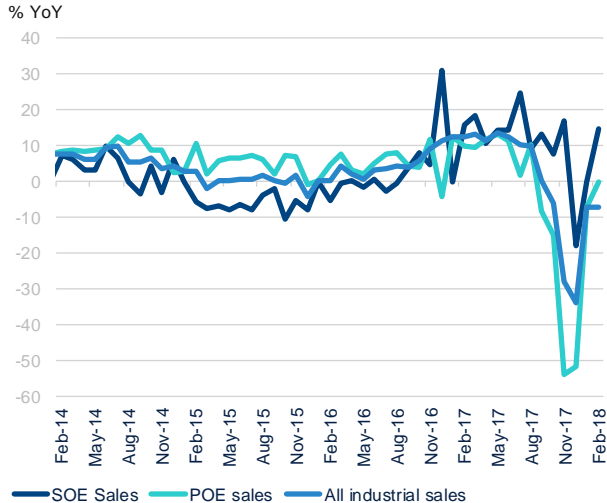


Source: NBS & BBVA Research

33% of China's listed companies are SOEs, accounting for 73% of assets, 74% of revenues, and 61% of employment. Leverage ratio for SOEs will be basically stable, which is one of the main economic targets for 2018

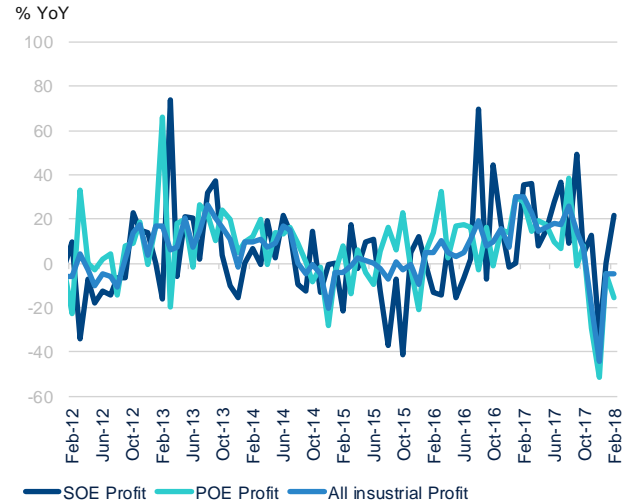
# SOEs profit has rebounded more than their POE peers

## SOE sales rebounded from the year-end low in 2017



Source: NBS & BBVA Research

## SOE profit also rebounded in recent months

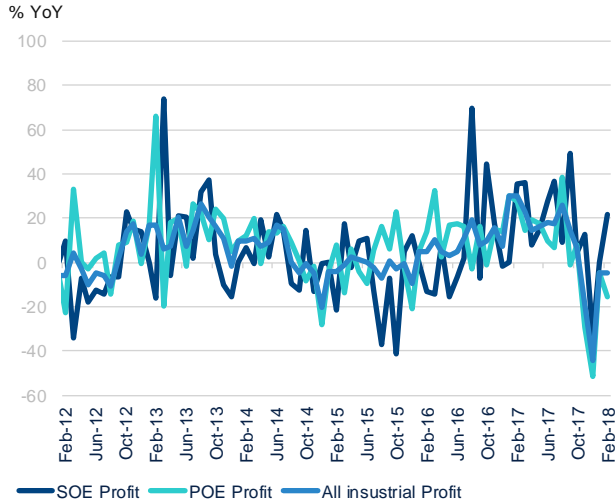


Source: NBS & BBVA Research

Both SOEs sales and profits rebounded then their POEs peers, benefiting from the supply-side reform

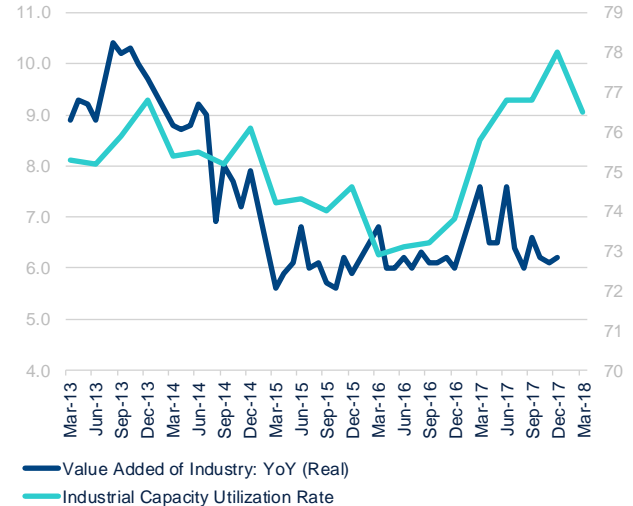
# Fixed assets investment of SOEs rebounded

## SOEs' fixed asset investment rebounded



Source: CEIC & BBVA Research

## Industrial capacity utilization rate soared



Source: CEIC & BBVA Research

SOEs investment regains its momentum at the beginning of the year, which grew at 8.9% ytd y/y in January-March from 7.7% ytd y/y previously

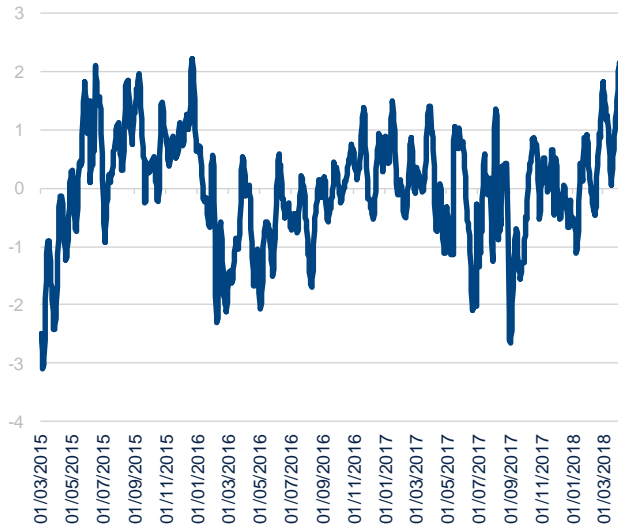




# 03

## The Housing Index

# Housing Bubble Vulnerability index

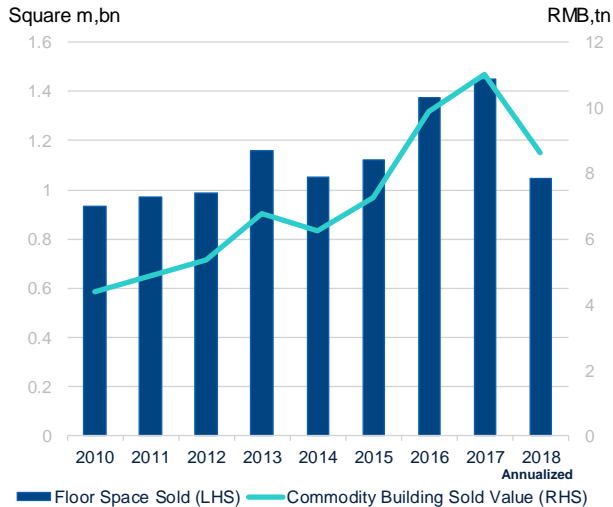


**Housing Bubble  
Vulnerability index  
deteriorate as  
property prices  
remained at high  
levels in many cities**

**But remained in a  
positive territory**

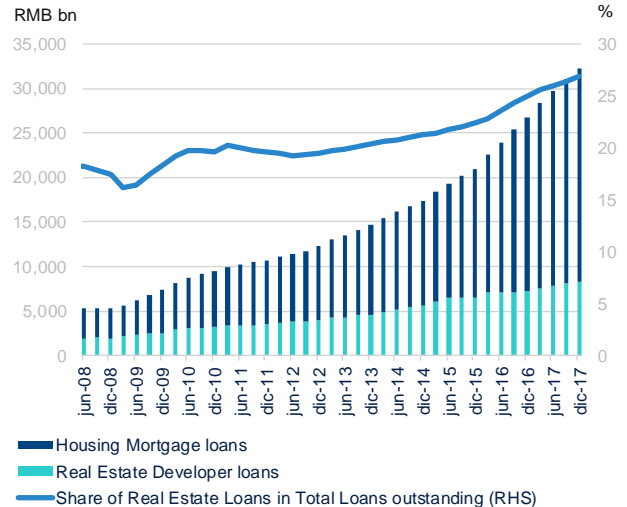
# Property sales were surprisingly strong in 2017, but will cool down in 2018

## Property sales hit a new high in 2017



Source: CEIC & BBVA Research

## The amount of mortgage loans continue to grow

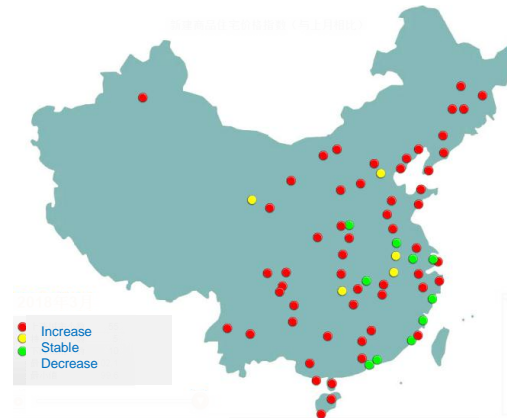


Source: CEIC & BBVA Research

Property sales reached a new high for the full year of 2017, which has prompted the authorities to further tighten mortgage lending in order to cool the market

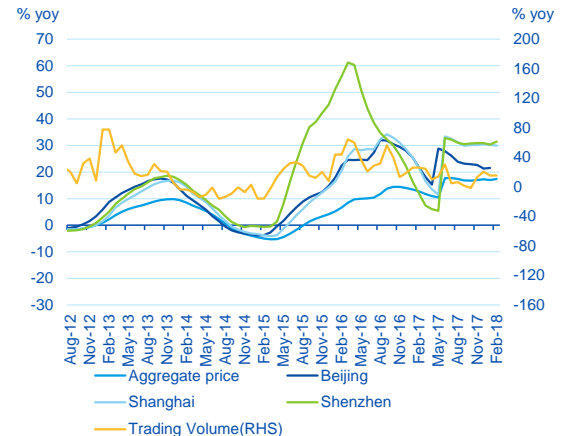
# Housing prices are strong in both central and coastal provinces

## Housing price MoM comparison among cities in March 2018



Source: NBS & BBVA Research

## Housing price growth decelerated in first-tier cities since mid-2016

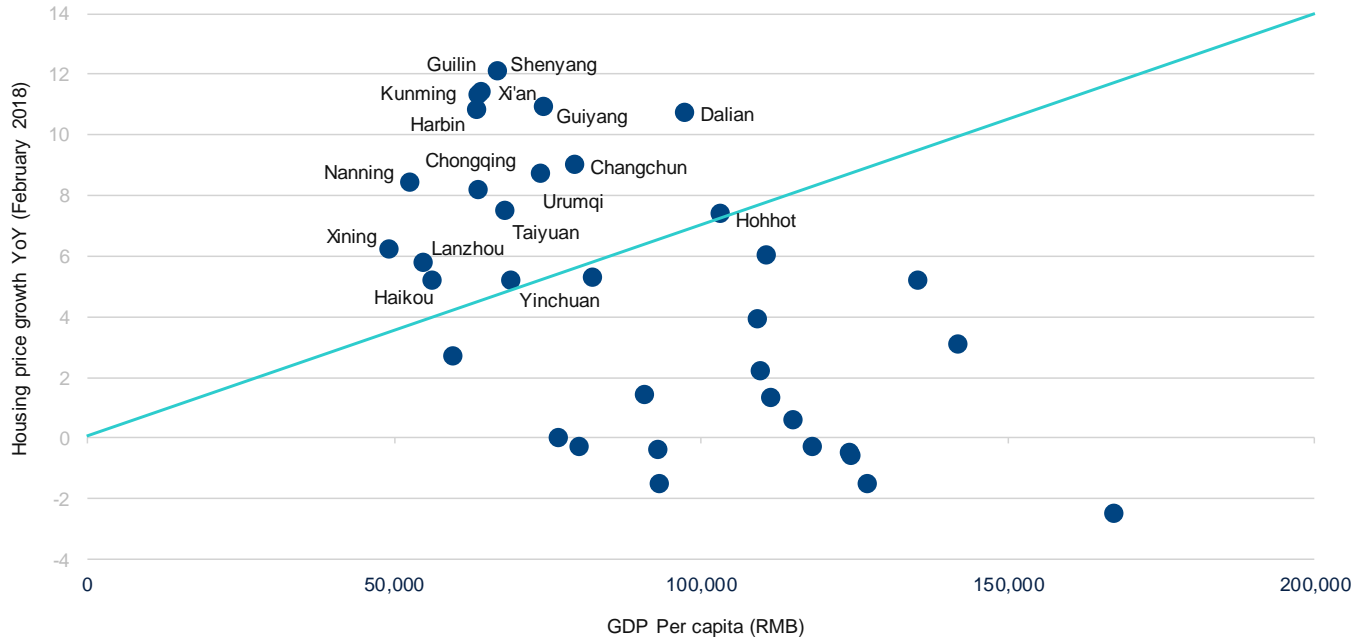


Source: CEIC & BBVA Research

Sales growth has been particularly strong in central provinces and some higher-income coastal provinces. On the contrary, property price seemed to be contained in a few first tier cities where very harsh measures have been implemented to cool off housing market

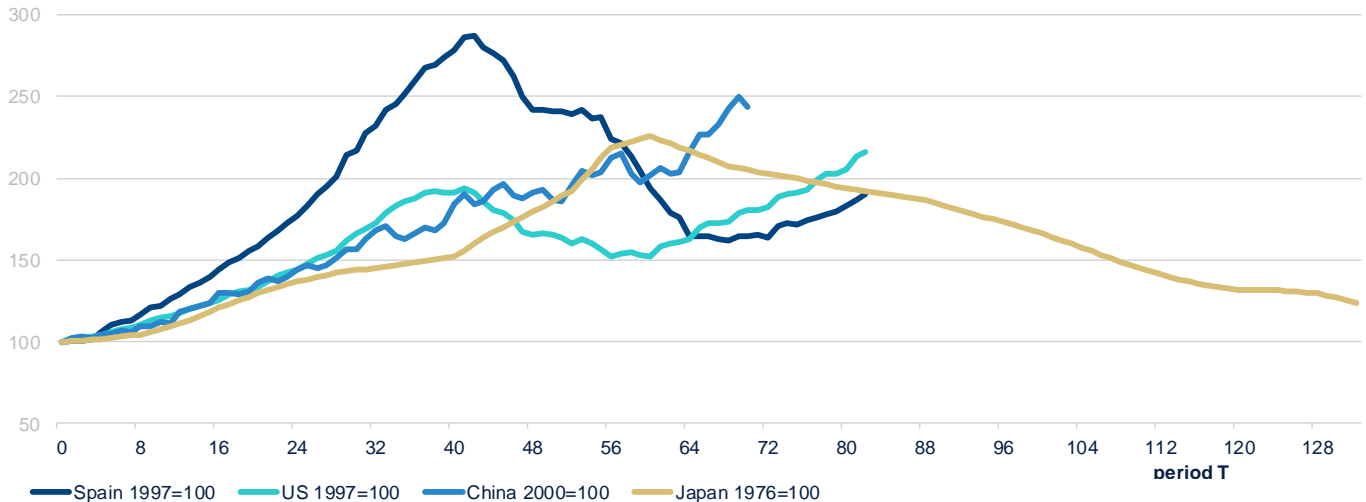
# Housing prices are strong in both central and coastal cities

## Central provinces and coastal cities enjoyed higher housing prices



# How high can China's house price go?

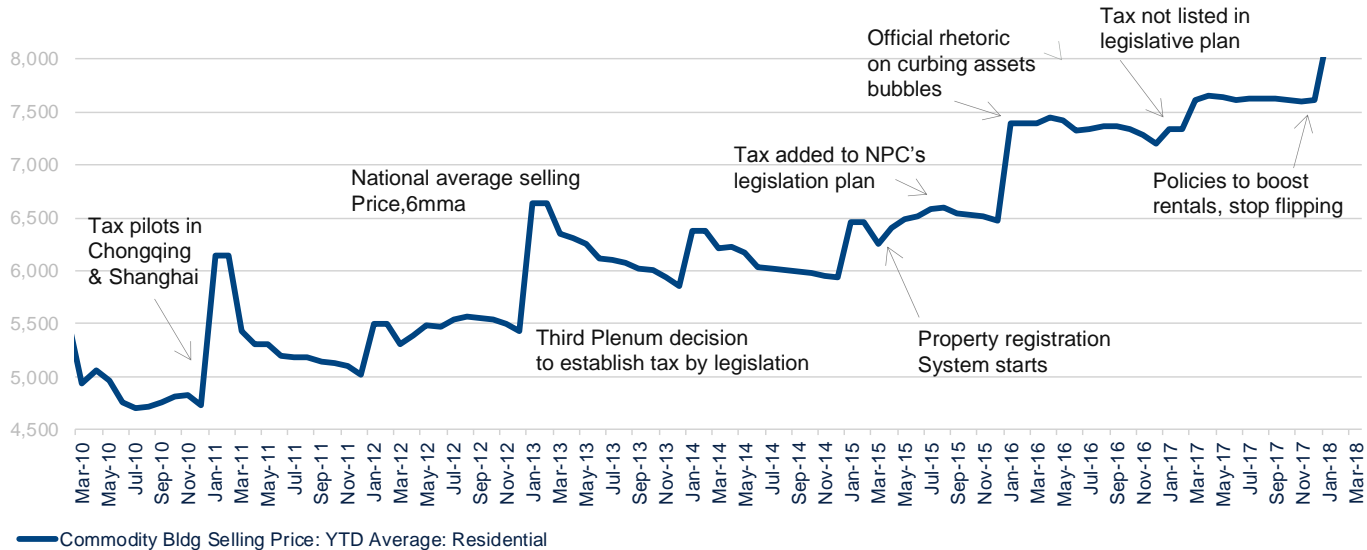
## International comparison of housing bubbles



Source: BBVA Research

Despite the recent slowdown since mid-2016, China's housing bubble still appears sizable compared with some precedents in advanced countries

# A property tax has been discussed for years as yet there is no clear path to reality



Source: CEIC & BBVA Research

As the overheating in China's housing market seems hard to curb, authorities have brought up the idea of imposing property tax again. This time it seems that they really want to put it into practice rather than just offering an empty promise.

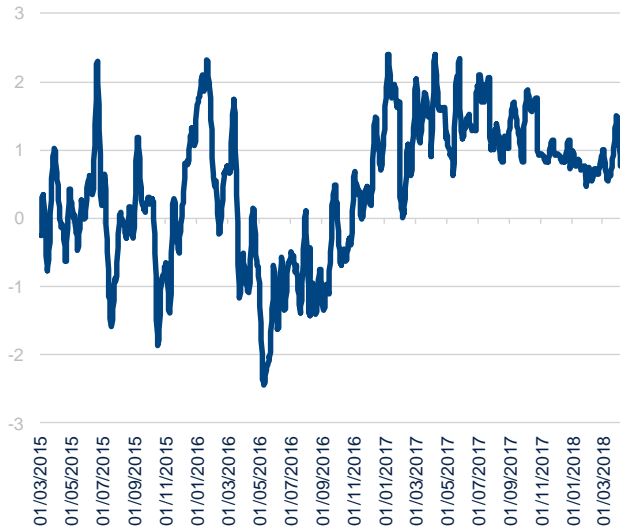


# 04

## The Shadow banking Index



# Shadow banking Vulnerability Index

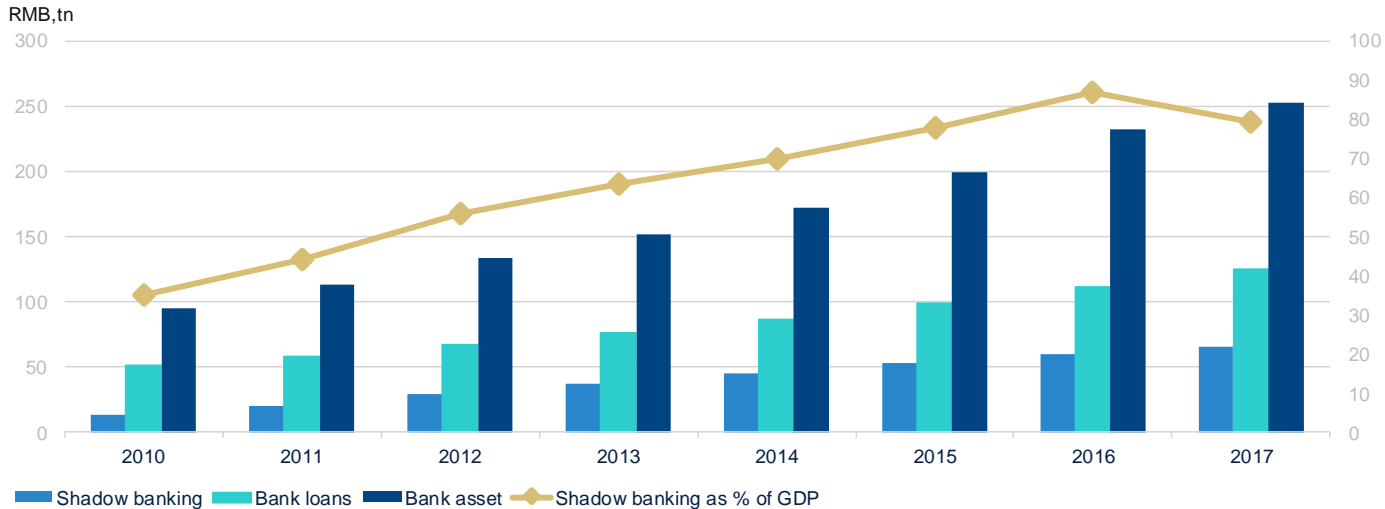


**Shadow banking vulnerability index remained in a positive territory due to government efforts to facilitate financial deleveraging**

**Financial regulatory storm continues, limiting the room for financial arbitrage**

# Shadow banking growth decelerated amid government clampdown

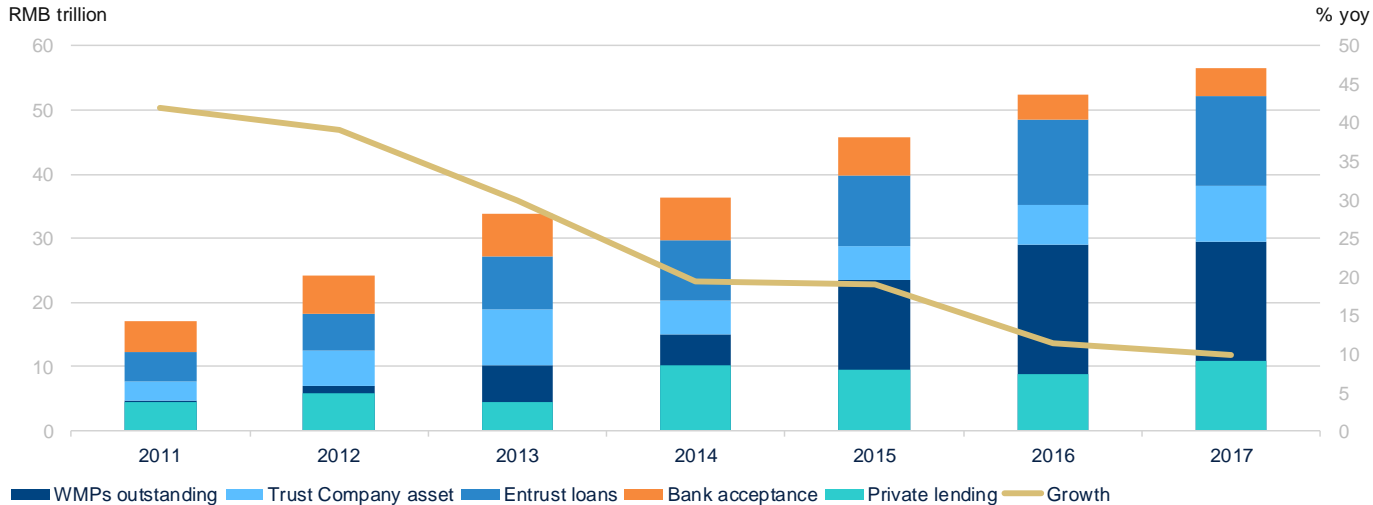
## Shadow banking growth moderated further toward end-2017



Source: CIEC & BBVA Research

Annual nominal GDP grew faster than shadow banking assets for the first time since 2002. This has led to a drop in shadow banking as a share of GDP to 79.3% at the end of 2017

# Shadow banking as % of GDP dropped as bank's WMPs and NBFIs asset management plans (AMP) slowed pace

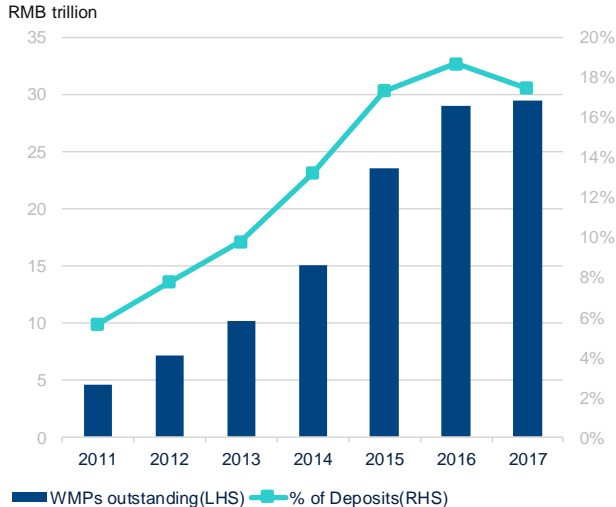


Source: CIEC & BBVA Research

WMPs and AMPs have under increasing pressure from regulators since the mid-2016. As a result, the outstanding shadow banking assets slowed its expansion pace in 2016 and 2017

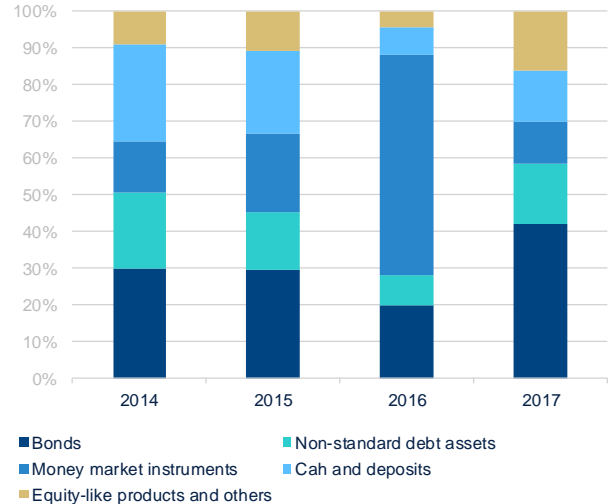
# Coordinated regulatory actions help to curb WMPs growth

## WMPs outstanding shrank in 2017



Source: CEIC & BBVA Research

## WMPs Composition shifts to equity-like products and others

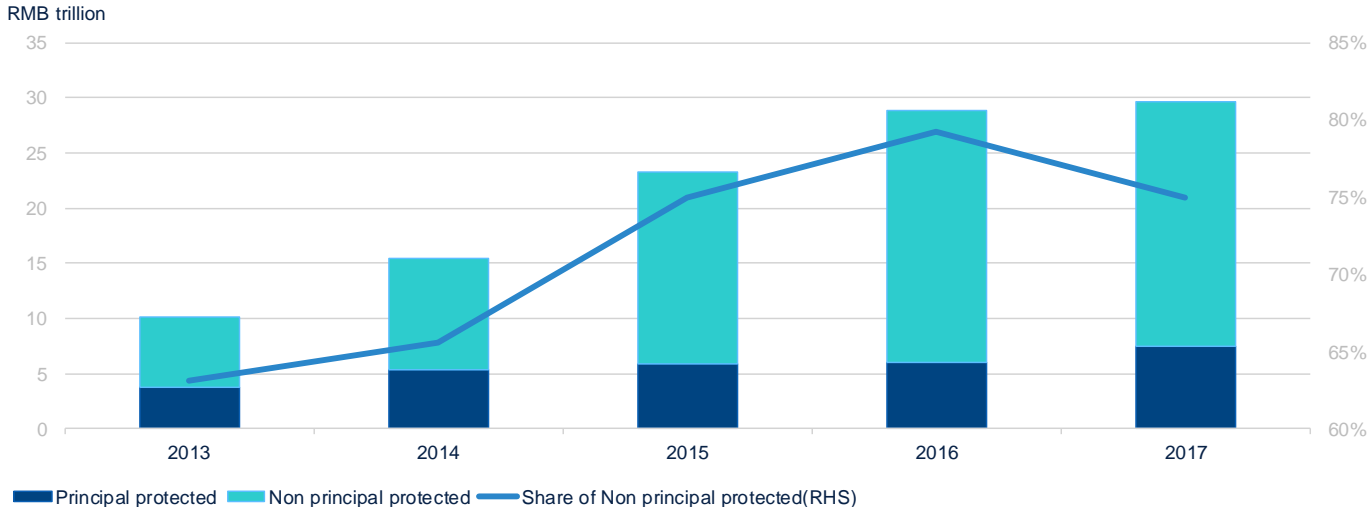


Source: CEIC & BBVA Research

Growth of bank's outstanding WMPs is likely to remain subdued in 2018 on tighter regulatory oversight. Regulator will implement stricter inspections on bank's WMPs businesses that are related to multi-layered investment, interbank transactions and off-balance sheet activities

# Decline in outstanding non-principal-protected WMPs

## Share of Non principal protected WMPs declined in 2017

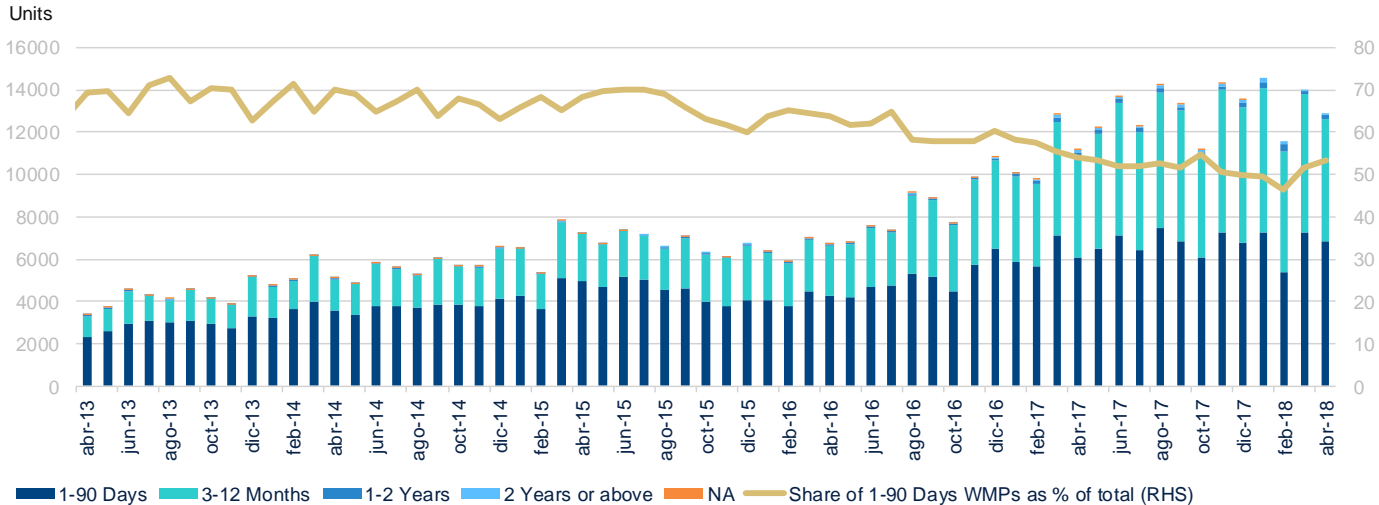


Source: China Banking Wealth Management Product Registration and Depository Center & BBVA Research

Off-balance sheet WMPs are not principal protected products, which fell 4% yoy at the end of 2017 following the inclusion of off-balance sheet WMPs into the PBOC's MPA framework from Q4 2017

# Addressing maturity mismatch between WMPs and underlying assets

## Maturities of newly issued WMPs

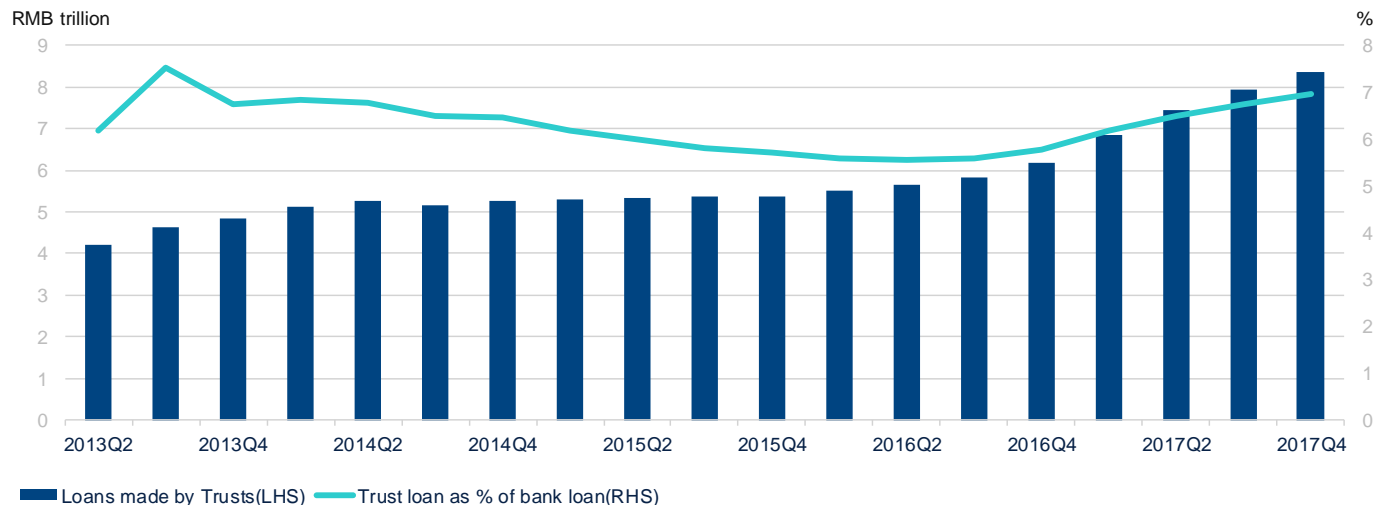


Source: Wind & BBVA Research

WMPs with short maturities below 3 months are still dominant among newly issued products, accounting for more than half of the total volume, but their share has been declining for five straight quarters

# Trust loans grew as regulations target other segments

## Growth in trust company loans

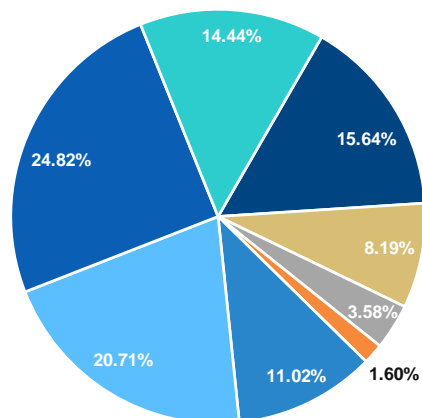


Source: China Trustee Association and BBVA Research

Trust loans expanded by around 30% in terms of outstanding lending in 2017. Tighter regulations on CSRC-regulated securities firms and fund subsidiaries have increased the use of trust loans as pass-through channels for banks and shadow credit

# Trust sector assets shifting to corporates and property sectors

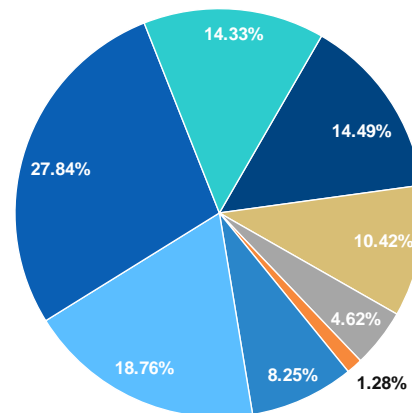
## Growth in trust company loans-2016



■ Infrastructure  
■ Real estate  
■ Securities markets (Bond)  
■ Financial institutions

Source: China Trustee Association and BBVA Research

## Growth in trust company loans-2017



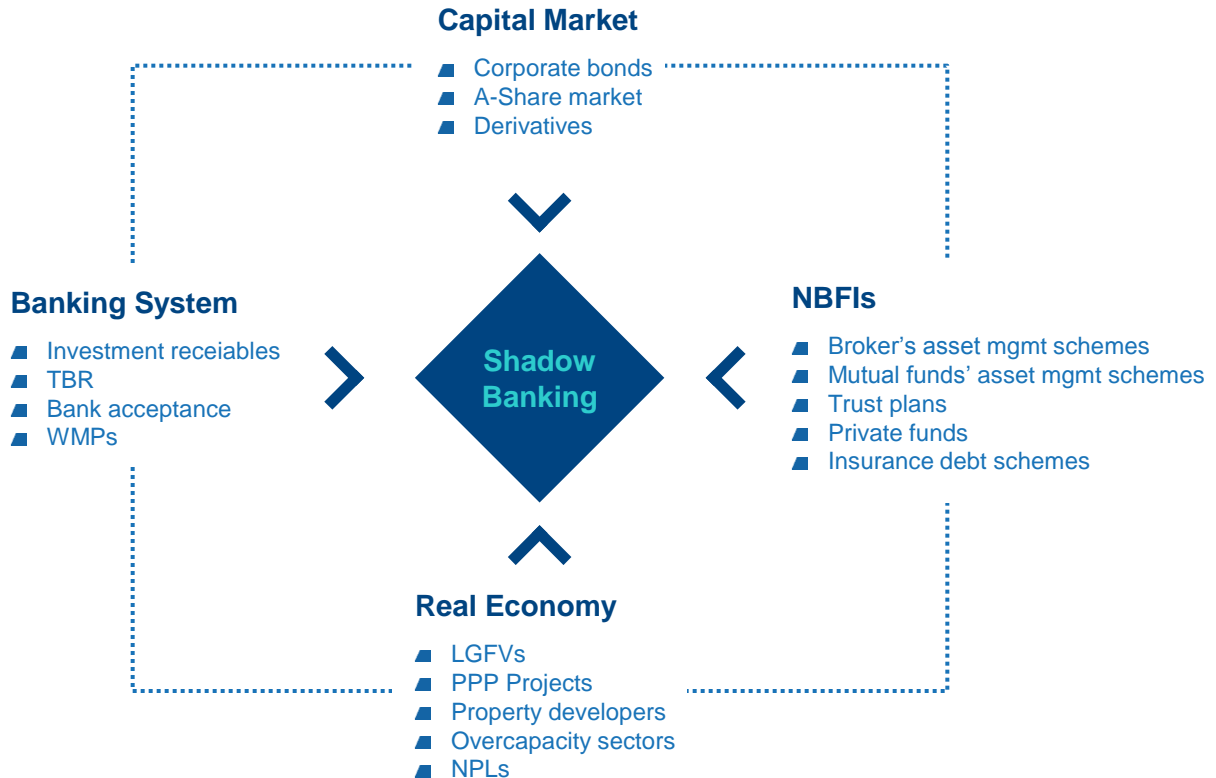
■ Securities market (Stock)  
■ Securities market (Fund)  
■ Business enterprise  
■ Other

Source: China Trustee Association and BBVA Research

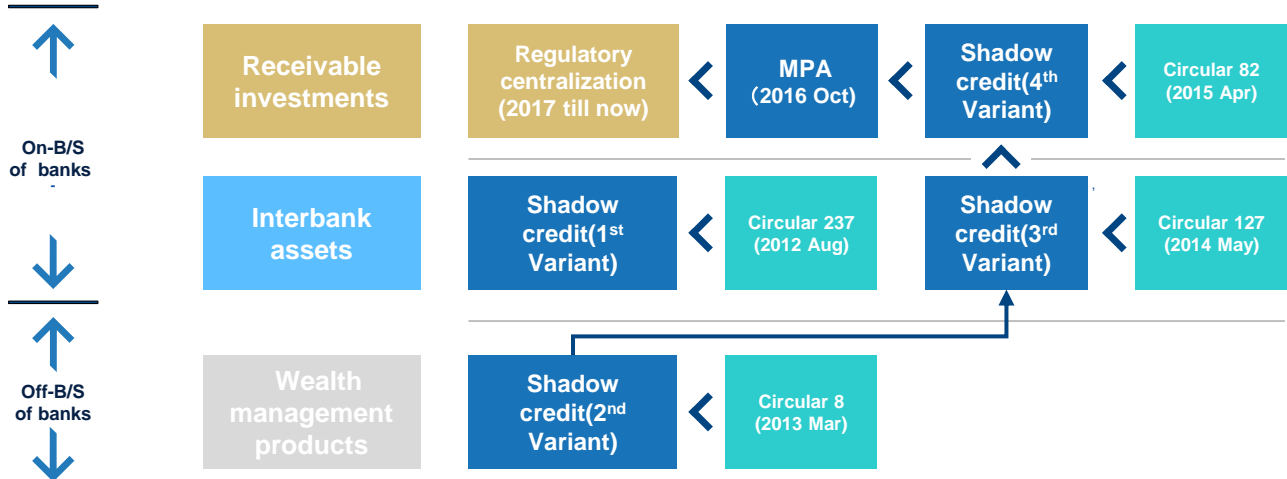
In December 2017, CBRC tightened scrutiny on bank's funding practices to property developers, LGFCs, and companies from overcapacity industries through the bank-trust cooperation business, which allows banks to channel credit to these sectors by investing in trust plans



# Shadow Banking connected with traditional banking was squeezed



# Regulations to curtail regulatory arbitrage



Source: Deutsche Bank, CBRC and BBVA Research

**Circular 237** requires banks put the “inter-bank refinance for trade” business into the loan account and thus restricted by the loan amount limit.

**Circular 8** requires the balance of the non-standardized creditor's rights assets (NSCA) is at the upper limit of the lower level between the 35% of the balance of the financial products and the 4% of the total assets disclosed by banks' previous annual audit report.

**Circular 127** stipulates that only financial assets with high liquidity can be used as the target of buying back the sale of financial assets, and the CBRC also requires banks to make corresponding capital and provision according to the nature of the underlying assets.

**Circular 82** aims to tighten the bank's transfer of non-standard credit assets (NSCA) to off-balance-sheet

# New regulatory measures will further restrain shadow banking growth in 2018

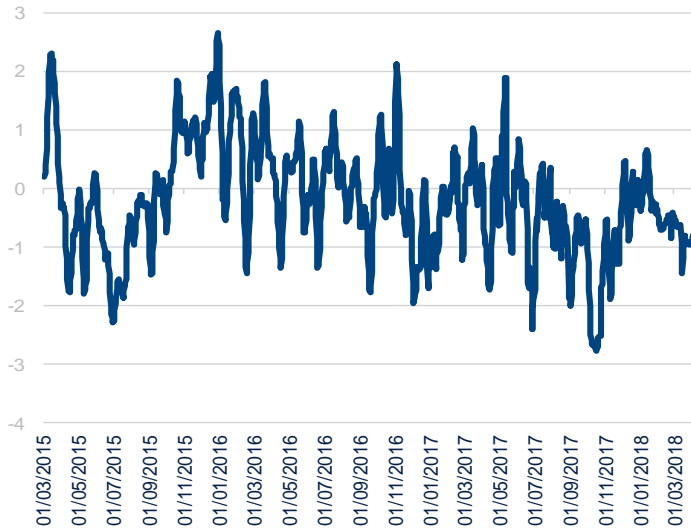
Date	Key regulatory development
2nd Jan	PBoC raised the RRR of Third-Party Payment institutions to 50% from the current 20%
3rd Jan	PBoC,CBRC,CSRC and CIRC banned the practice of using other institutions' accounts to participate in bond trading to avoid regulatory arbitrage and putting limits on repo and reverse repo business for financial institutions
5th Jan	CBRC stipulated bank's maximum exposur for a sing client:outstanding loan<=10% of total capital etc
5th Jan	CBRC clamped down on connected transactions between commercial banks and their major shareholders
6th Jan	CBRC clamped down irregularities of entrust loan business(company-to-company loan with a bank as the monitor)
27th Feb	PBoC encouraged banks to issue CoCo bonds to supplement capital ahead of the tighter international regulatory standards of TLAC that will come into effect from Jan 1,2019
28th Feb	CBRC eased rules requiring lenders to set aside provisions against losses on bad loans: reduce the minimum NPL coverage ratio from 150% to 120%,and reduce the minimum LLR cover of total loans from 2.5% to 1.5%
22th Mar	China proposed to merge its banking and insurance regulator in a move to plug regulatory loopholes that have enabled risky forms of shadow banking
27th Apr	China unveiled far-reaching rules on the asset management sector,including regulations on leverage limits and a ban on implicit guarantees.The total assets to net assets ratio will be capped at 140% for open-end mutual funds,and at 200% for closed-end and private funds,effective after the end of 2020.Financial institutions will also be required to provision 10% of their commission income from asset management products as risk reserves.They will also be forbidden from creating a "capital pool" to manage funds raised through asset management products,a practice that has allowed banks to roll over products constantly,with any investment losses implicitly covered by the issuance of a new product.Investors will be banned from pledging their shares in asset management products as collateral to obtain financing,a practice that increases leverage.Financial institutions will not be allowed to use asset management products to invest in commercial banks' credit assets or provide"channel service for other institutions to bypass regulations.Non-financial institutions will be prohibited from issuing or selling asset management products.State-owned firms must report their investment in financial institutions to the Communist Party Central Committee and State Council.Non-financial firms cannot borrow funds to invest in financial institutions and controlling shareholders of financial institutions must meet certain requirements on profits and asset ratio



05

The exchange rate Index

# Exchange Rate Vulnerability Index

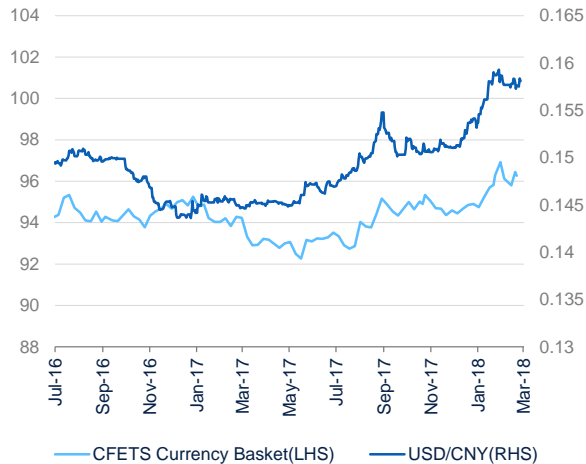


**Exchange Rate Vulnerability Index plummets to the negative territory due to a faster-than-expected RMB appreciation...**

**In the past negative sentiment was generally caused by the RMB depreciation**

# RMB valuation regime shifts from capital-account-based to current-account-based

Recently appreciation significantly against USD as well as the CFETS basket

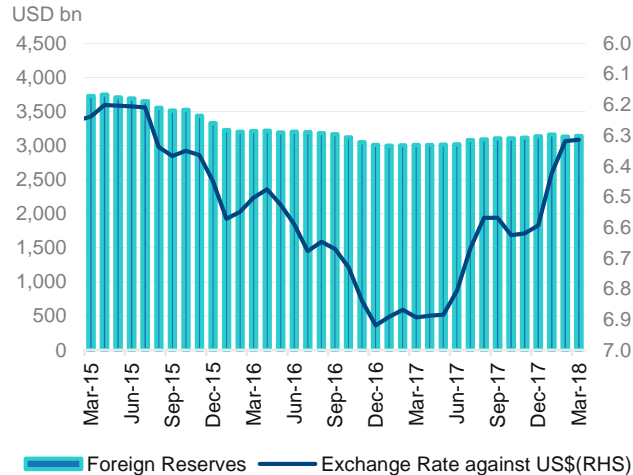


Source: BBVA Research and CEIC

- The effective tightening under the capital account targeting at Chinese financial oligarchs (Anbang, Wanda, HNA etc.)
- With the capital account under tight grip, the recent movements of the RMB mainly reflect current account changes
- The authorities are likely to pursue a clean-float with a managed capital account. No one-off liberalization
- We substantially revised our 2019 forecast to 6.55, reflecting both recent CNY appreciation and new policy tendency

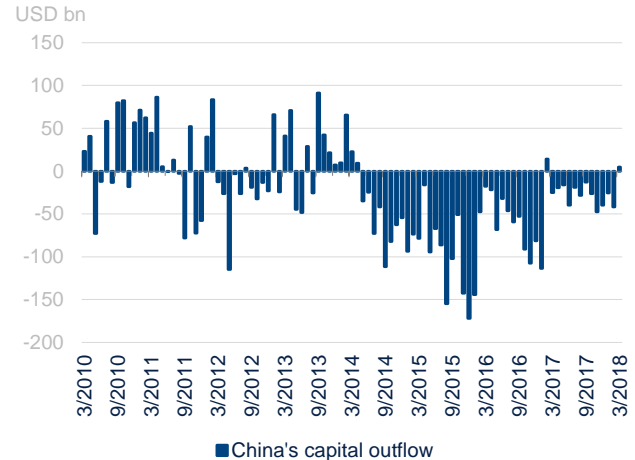
# The level of FX reserves stabilized

## Foreign reserves declined in February after a 12-month growth in a row



Source: BBVA Research and CEIC

## Estimated historical capital outflows



Source: BBVA Research

“Two-way” change of foreign reserve and capital outflow is expected in the future

The authorities have stealthily relaxed OFDI in support of OBOR

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