
China Banking Monthly

Credit Tightening Won't Last

- **Interviews – Capital Controls Will Fade**

Our interviews with local traders, economists and bankers suggest Beijing's tighter controls on capital flight are unlikely to last. These controls have been effective in February/March at the expense of normal business activity. We also outline five possible policy choices for the RMB below.

- **Analysis - Declining Overseas Borrowing**

There is significant confusion over the composition in the decline of China's foreign currency reserves. Is the decline due to false trade invoicing, service flows, or other factors? We think the data suggests that reduced overseas borrowing by Chinese corporates is a significant contributor to the decline.

- **Liquidity Watch - Rise in Interbank Lending.**

Interbank loans and reverse repos continue to rise, driven by high demand for credit between institutions. The largest consumer of loans continues to be the corporate sector, whose loans grew 14.9%. However, the biggest jump in credit occurred with "other" financial institutions, whose loans rose 79.2% YoY. Clearly interbank lending has shifted from unregulated "entrusted" loans, to the more regulated interbank sector.

Interviews

Capital Flight Likely to Resume

Arguments for Less Capital Flight

Declining Short-Term Pressure. "The momentum of rapid outflow of domestic capital seems to have stopped. Pressure has been relieved at certain levels." For instance, net foreign exchange sales by China's central bank fell more than 50 percent to US\$35.1 billion in February. (*Senior officer at a mid-size bank in Shanghai.*)

More Controls Ahead. "Although the central government has denied adding additional capital controls, we've already made it more difficult for individuals to purchase foreign

exchange using the RMB. It's a common practice among our peers, under orders of the government. For example, we've stopped the foreign exchange business with the third-party agencies that usually break up a sum of money into parts like -- ants moving -- by using the maximum foreign exchange purchase limit with one identity and then wire to China's central bank fell more than 50 percent to US\$35.1 billion

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Restrictions on False Trade Invoicing. "More frequent check on swift codes is a new order we recently received from the head office as a result of rising concern over capital flight. For instance, we're increasingly cautious about 1) multi requests under same swift code; 2) questionable weight, port of shipment, and container numbers on freight.

Specifically, we'll reject: 1) same port of loading and discharge; 2) date of the swift code is earlier than either the date of the contract or the opening date of the Letter of Credit. Although this could effectively stop capital flight through false trade invoicing, I don't think it will last long as it also largely impedes normal trading activities." (*Manager at the Trade Finance Department of a commercial bank in Shanghai.*)

Lower Forex Incentives. "I've heard most banks have canceled internal incentives for forex sales. To some degree, this will eliminate part of the capital flight encouraged by the banking system itself." (*Branch manager at middle sized bank*)

No RMB Shorts. "We expect the inverse relationship between the U.S. dollar index and RMB to intensify in the short-run while the latter remains stable in the short-run. In addition, there's little possibility that foreign institutions will take a short position here." (*Chief economist at a state-owned fund.*)

Overseas Institutions Blocked. "We are already told what to do in case overseas institutions short the RMB. For instance, SOE banks will purchase RMB and sell US\$. Also, stricter capital controls will be applied to stop any kind of outflow no matter whether it is legal or is a normal business need." (*Senior Officer in charge of FX business for a state-owned bank*).

Argument for Rising Capital Flight

Controls Will Be Short-Term. "There's no doubt that Chinese government can largely control capital flight in the short-run given different measures taken. However, it will be hard to find a balance in the long-run as the economy relies on exports." (*Senior officer at SOE*)

bank).

Fed Policy is Key. “Expectations of further depreciation of the RMB is collapsing. The RMB should stabilize in the short-run. However, we’re watching closely the change in expectations for an interest-rate increase from the Federal Reserve.” (*FX trader at an international bank.*)

Unexpected Devaluation? “If the US\$/RMB maintains at a level of 6.5 for some time, the PBOC might do something out of everyone’s expectation like raise the US\$/RMB central parity to a much higher-than-expected degree in order to lower expectation of one-way appreciation.” (*FX trader at a state-owned bank.*)

Five Policy Choices for the Currency

An economics professor at the Shanghai University of Finance and Economics posited five choices for the currency:

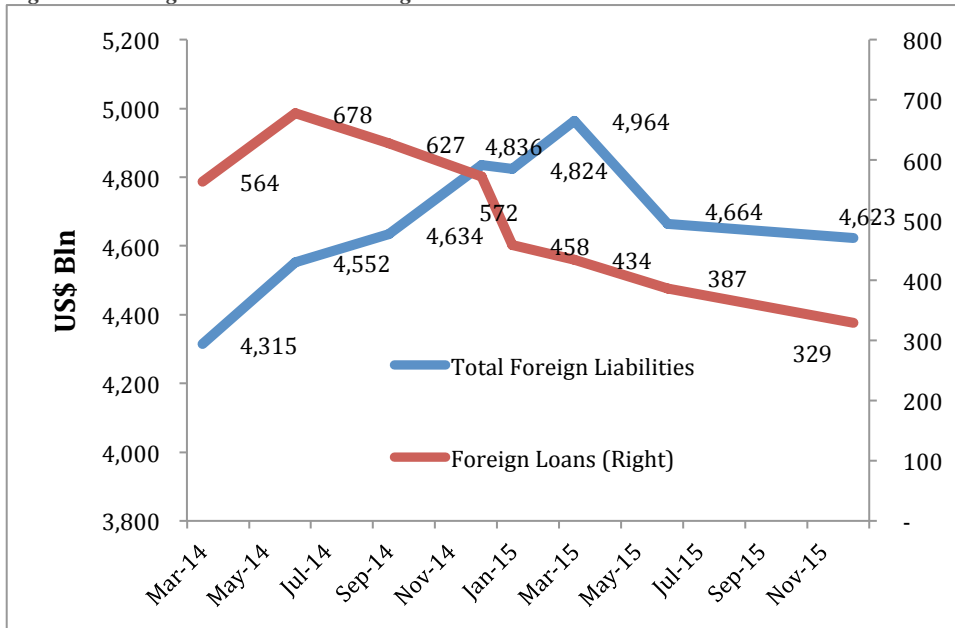
“In general, there are five FX policy forecasts in the market. First is to allow the RMB to depreciate gradually or have a one-time devaluation to a suitable level. Second is to maintain the stability of RMB against the US\$ -- not the basket of currencies, which is what the market most concerned about. Third is to let the RMB fluctuate in a wide range, +/- 7.5 percent. Third is to let the RMB fluctuate in a wide range, namely, plus or minus 7.5% compared to a basket of currencies. Fourth is to maintain the foreign exchange reserves. The last would require a formal link of the RMB to a basket of currencies, which currently is informal.”

Analysis

Drop in Reserves Due to Fall in Overseas Loans

There is significant confusion over the composition in the decline of China’s foreign currency reserves. Is the decline due to false trade invoicing, service flows, or other factors? We think the data suggests that reduced overseas borrowing by Chinese corporates is a significant contributor to the decline. Total foreign liabilities fell US\$213 billion from a peak of US\$4,836 billion in December 2014 to US\$4,623 billion in December 2015. Of that total, loans in a foreign currency fell US\$243 billion from US\$572 billion in December 2014 to US\$329 billion in December 2015. The decline in loans accounted for most of the decline in foreign liabilities.

Figure 1 - Foreign Liabilities and Foreign Loans



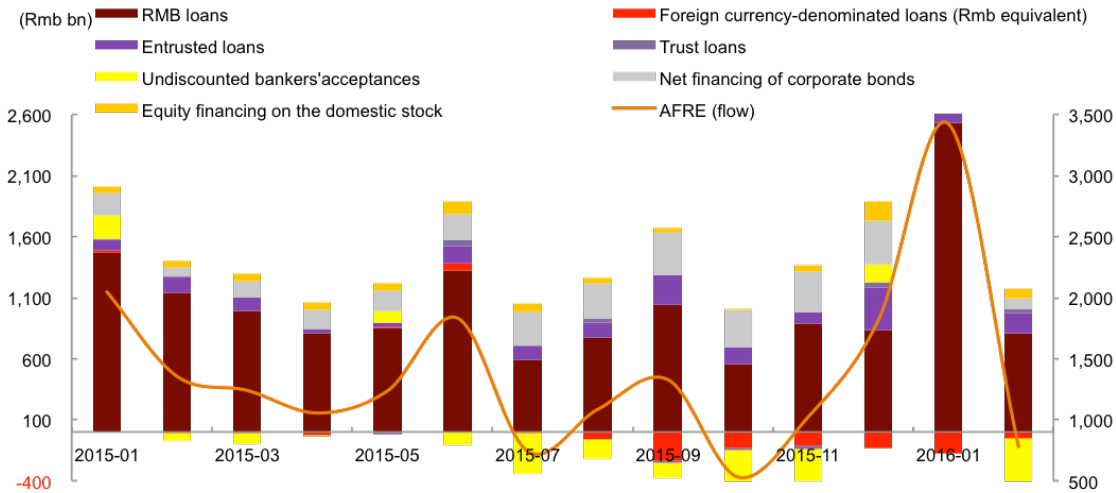
The decline in foreign liabilities has been driven by a sharp drop in overseas borrowing by Chinese corporates, or more likely, loan repayment.

Liquidity Data

Aggregate Liquidity

New sources of capital were low during the Chinese New Year January-February period but were higher than a year earlier. Corporate bond issuance slowed to a crawl and there was a sharp reduction in entrusted loans, which are a form of Shadow Banking between banks and corporates. This likely reflects continued curtailment of these unregulated loans by the China Banking Regulatory Commission.

Figure 2, Aggregate Liquidity

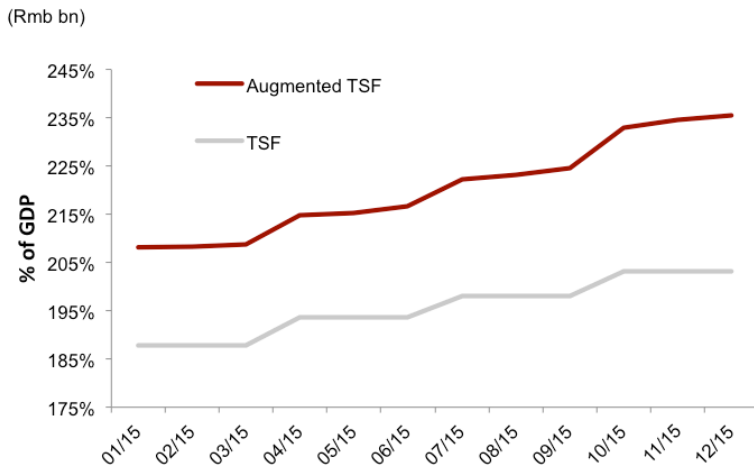


Monthly total social financing flows show that liquidity picked up in January and February of this year.

Total Financing in the Economy

China has used Total Social Financing as its measure of the growth in liquidity in the economy. However, that excludes two fast-growing categories, non-loan claims on the non-financial economy, and claims on government. These two categories rose from RMB13.8 trillion in January 2015 to RMB22.0 trillion in December 2015.

Figure 3, Augmented TSF

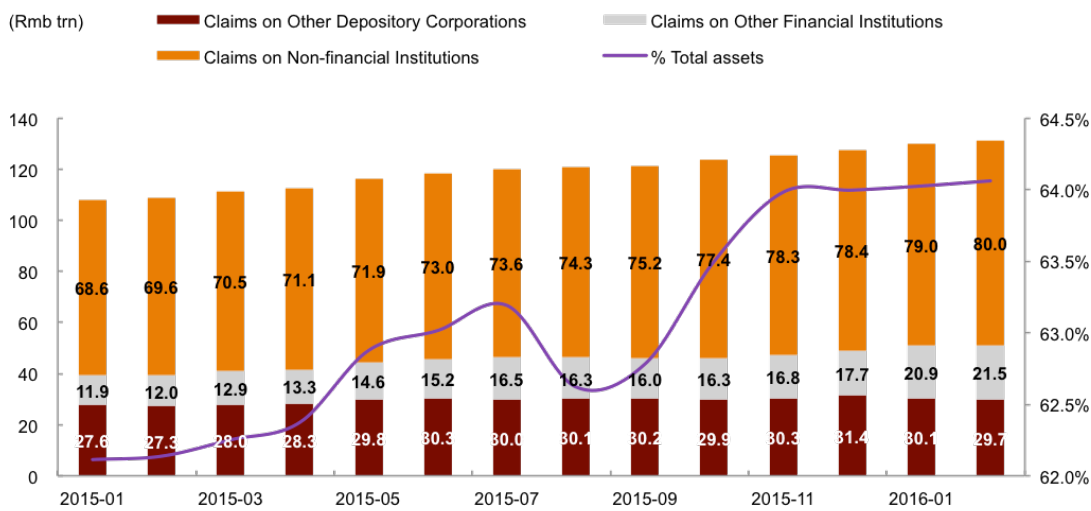


Augmented total social financing continues to grow at an accelerated pace.

Loan Destination

The largest consumer of loans continues to be the corporate sector, whose loans grew 14.9%. However, the biggest jump in credit went to other financial institutions, rising 79.2% YoY. Clearly interbank lending has shifted from away from entrusted loans to the more regulated interbank lending.

Figure 4, Breakdown of Liquidity by Destination



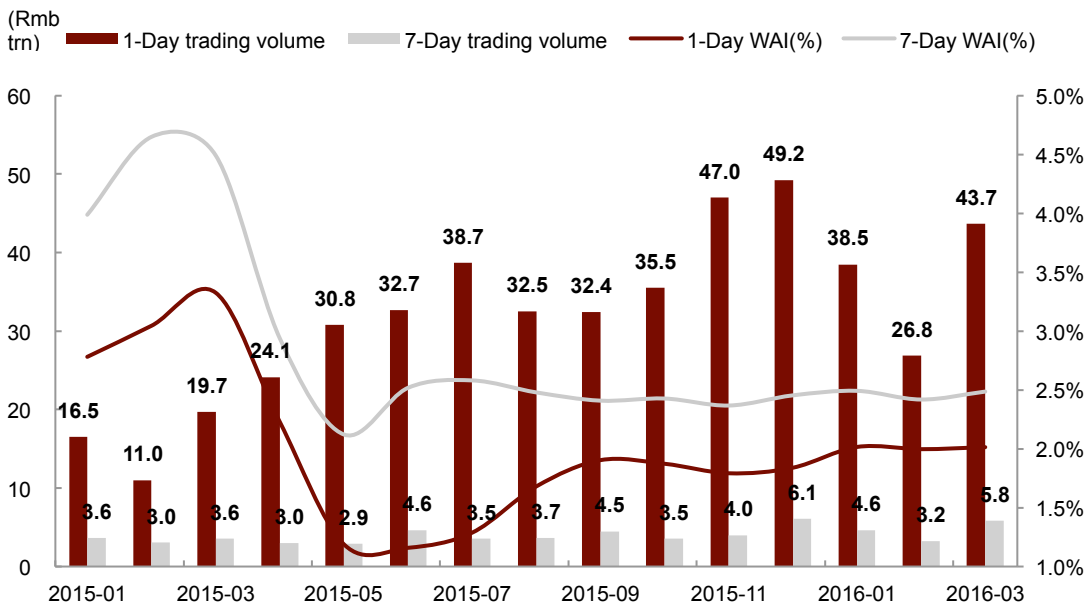
Credit flows in the interbank market have shifted back towards bank-to-bank credit extension.

Interbank Repos

Credit flows in the interbank market have shifted back towards bank-to-bank credit extension.

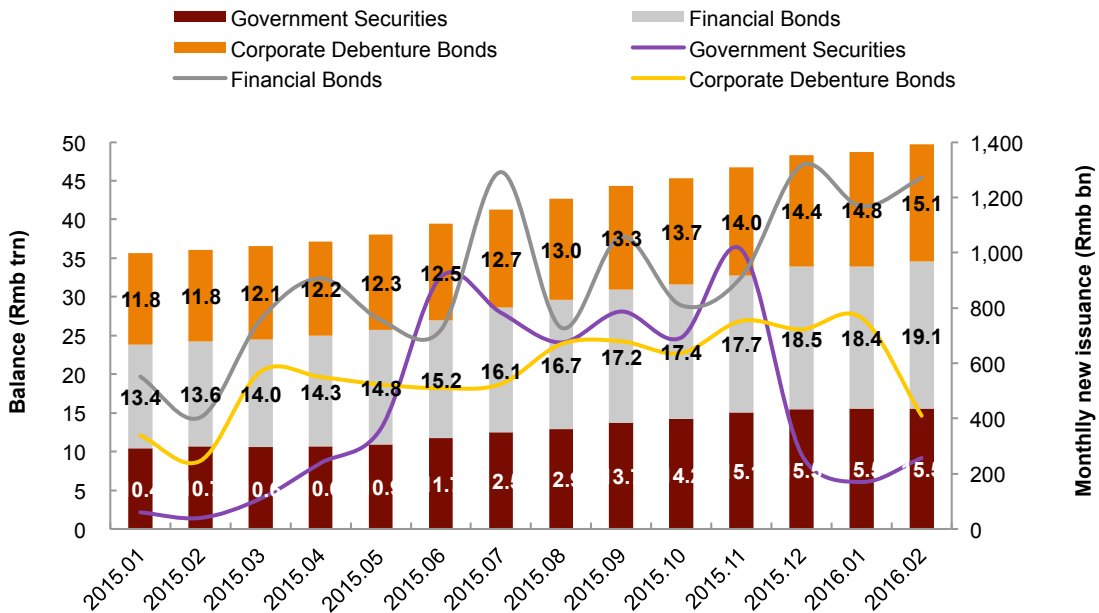
We can see the increase in interbank activity also in the strong growth in Interbank Pledged Repos. Daily volume in March 2016 soared 120% to RMB43.7 trillion, close to the 12-month peak in December 2015 of RMB49.2 trillion.

Figure 5, Interbank Credit



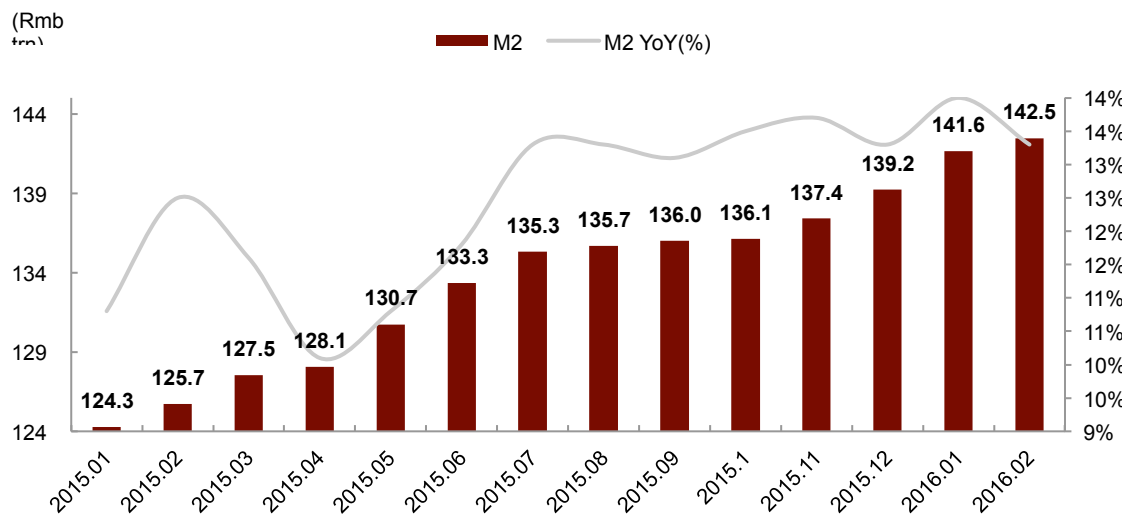
Interbank rates remain stable despite the pickup in credit during the beginning of the year.

Figure 6, Debt Securities



Bond issuance continues to grow in line with government efforts to promote “direct finance” over bank lending.

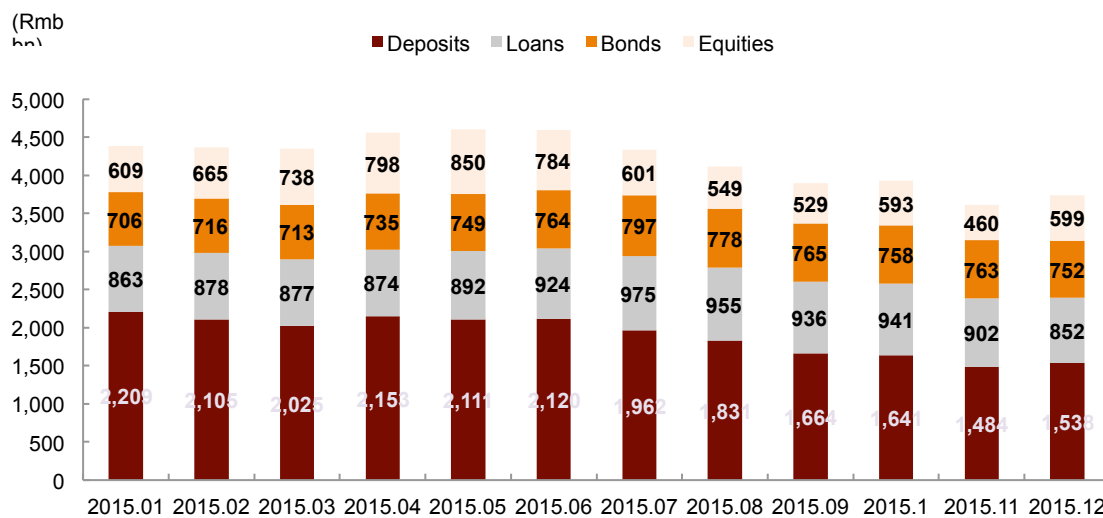
Figure 7, Money Supply



M2 growth remains stable, but high.

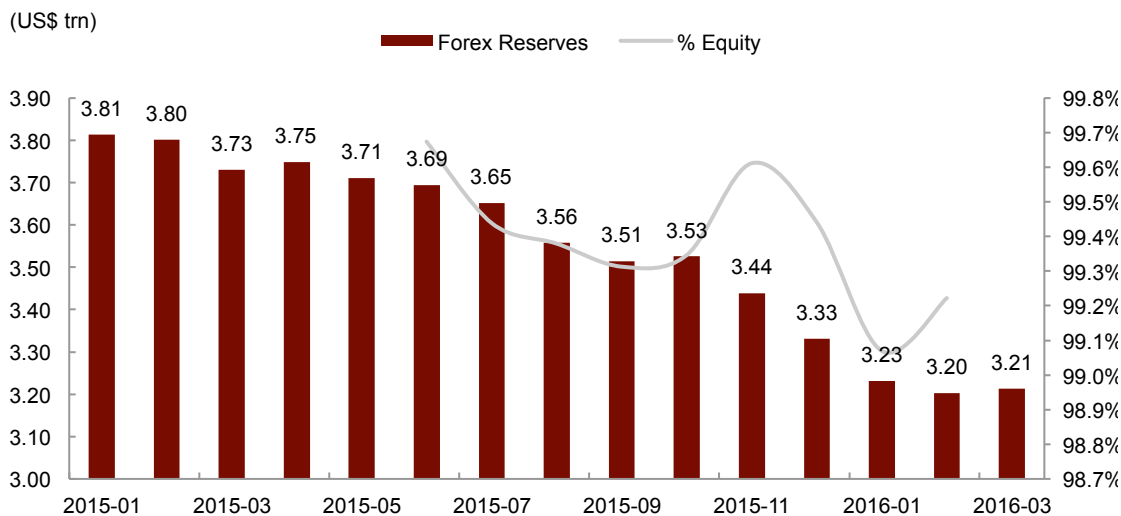
International Flows

Figure 8, Overseas Purchases of Domestic Assets



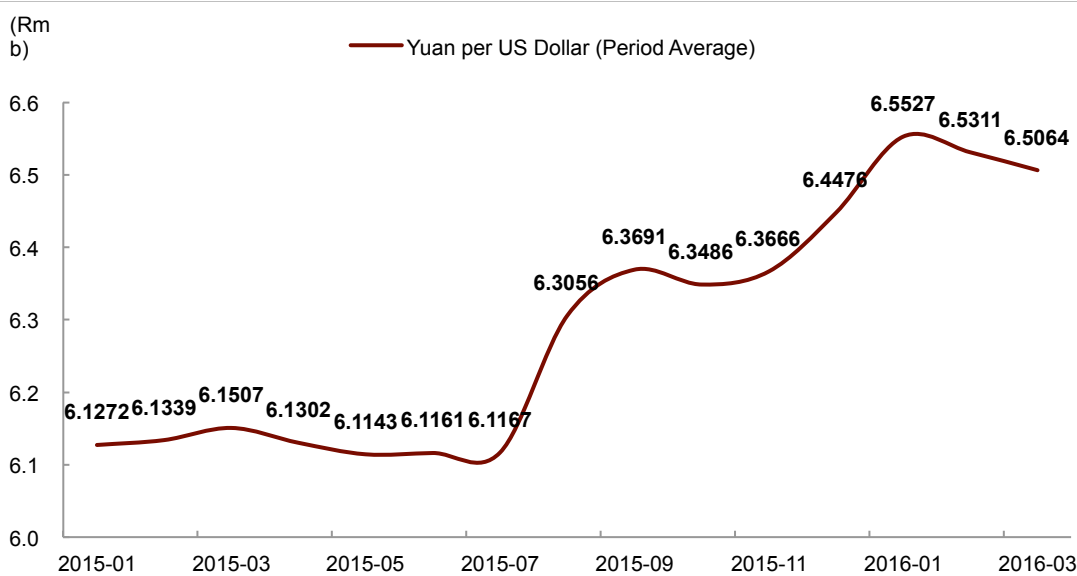
Foreign holdings of Chinese financial assets remains below last year's levels.

Figure 9, Foreign Exchange Reserves



Chinese foreign exchange reserves have stabilized after a sharp fall during Q4 2015.

Figure 10, Value of the Currency



Depreciation has paused due to intervention by the PBOC and verbal comments by Governor Zhou Xiaochuan.

END

