Orient Capital Research

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Andrew Collier, Managing Director
852-9530-4348
andrew@collierchina.com

Juilice Zhou, Analyst, Shanghai
Pat Chan, CFA, FRM Hong Kong

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The PBOC's New Forex Strategy

Tapping Foreign Loans to Reduce Capital Flight

Chances of Success are Slim

Summary

As China's economy slows, the country's economic leaders have been cycling through stimulative policies, finding creative ways to generate additional leverage in a system already over-leveraged. In 2015, the **stock market** was view as an easy source of capital, to be pushed up and then used as a giant piggyback for debt-ridden state firms to tap into through new equity issuances. That policy failed because there were inadequate resources to prop up the market and investors in the end did not believe the government would support the market.

In 2016, the unofficial macroeconomic policy was to utilize the **consumer** as a source of capital. Both PBOC and banking officials said in interviews that they believed that the consumer was "underleveraged" (their words) and should be utilized for additional loans. After all, they noted, consumer lending, although rising, remained below international norms. This strategy continuea as is apparent in the continued rise in the sale of private investments (Wealth Management Products.)

In February, the precipitous drop in China's foreign exchange reserves below the psychologically important number of $3 trillion has spurred the PBOC and senior politicians to alter tactics. It appears that the new stratagem to avoid the actual process of deleveraging is to **access foreign sources of capital.**

February 7, the PBOC reported that reserves fell $12.3 billion to $2.998 trillion, surprising the market, which had been expecting the PBOC to maintain a level above $3T or a consensus estimate of $3.004 trillion estimate. "This will further ramp up pressure on Chinese policy makers to prevent the further draining of reserves," said Rajiv Biswas, Asia-Pacific chief economist at IHS Global Insight in

Singapore, told Bloomberg.

Over the past two years, previous tools to stem capital flight included examining corporate overseas purchases, restricting individual capital flows, curtailing offshore mergers, and other bureaucratic methods that avoided a freely convertible currency. Clearly, these measures are not entirely effective. So to stem the flow, the PBOC is requesting corporates to *borrow offshore.* According to one SOE banker in Beijing:

There are no new restrictions. The PBOC is encouraging businesses that need foreign exchange to borrow offshore and transfer the USD funds back to China.

The PBOC's new cross-border financing policy allows firms to obtain foreign loans worth up to twice their net assets. Firms must repay loans with interest. SAFE's spokesman has officially declared that foreign loans are expected to grow in 2017.

Unrealistic Strategy

Why do this now? Clearly, the PBOC feels it is losing control of capital flowing out. This solution has a double goal: constrain outgoing capital and increase liquidity through non-Chinese sources, avoiding an increase in domestic debt. This latter policy is important; the PBOC is concerned with the stability and funding structure of the domestic banks. The banks increasingly have turned to the consumer (through WMPs) for their funding. Much of this growth has been concentrated in the smaller banks.

The surprise January 20 cut in the banks' Required Reserve Ratio (RRR) was an effort by the PBOC to help out the smaller banks. While the RRR cut was incorrectly viewed as a liquidity measure for all of the banks, it was in effect a *bailout of the smaller banks by the larger, state-owned banks.* As one banker noted, "There is a lack of liquidity in the market. The big banks are the fund providers and the other banks are borrowers. The PBOC is giving liquidity through the Big 4 (RRR). (See our earlier note, "Interbank Bailout.")

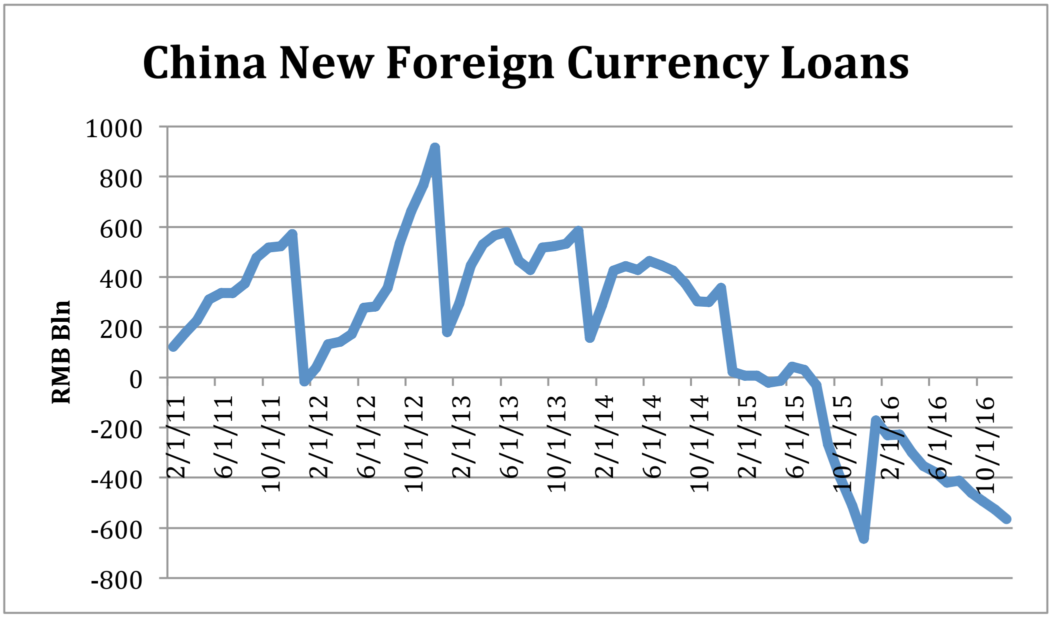
So the PBOC would prefer to avoid using domestic sources of credit. Hence the move offshore.

Overseas Borrowing Unlikely to Succeed

Unfortunately, the new policy reminds me a lot of the stock market bailout. More wishful thinking on the part of the Beijing leadership.

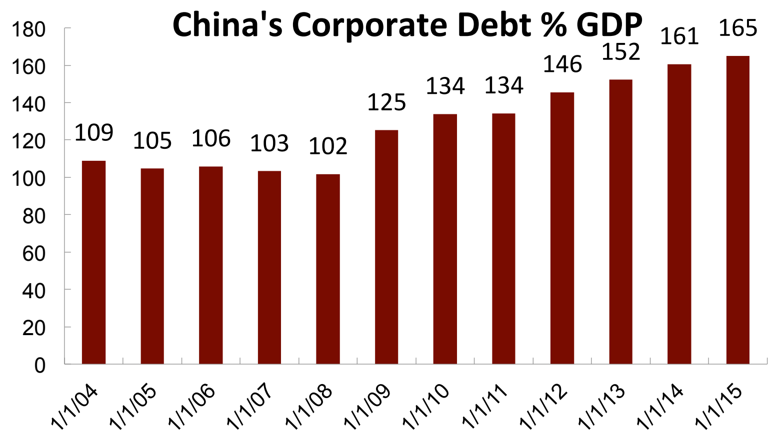
Over the last few years, most foreign banks significantly reduced their exposure to

China. New foreign currency loans to China peaked at RMB767 billion in November 2012. Since then, monthly growth in new foreign loan has steadily declined and actually turned negative beginning in April 2015. Clearly, the slowing economy, rising corporate debt, and the weakening currency caused banks to flee the market. In October and November of 2016, new foreign loans fell by RMB494 billion and RMB525 billion, respectively – a rapid pace of liquidity withdrawal and a clear vote of "no confidence" in the Chinese economy/currency.

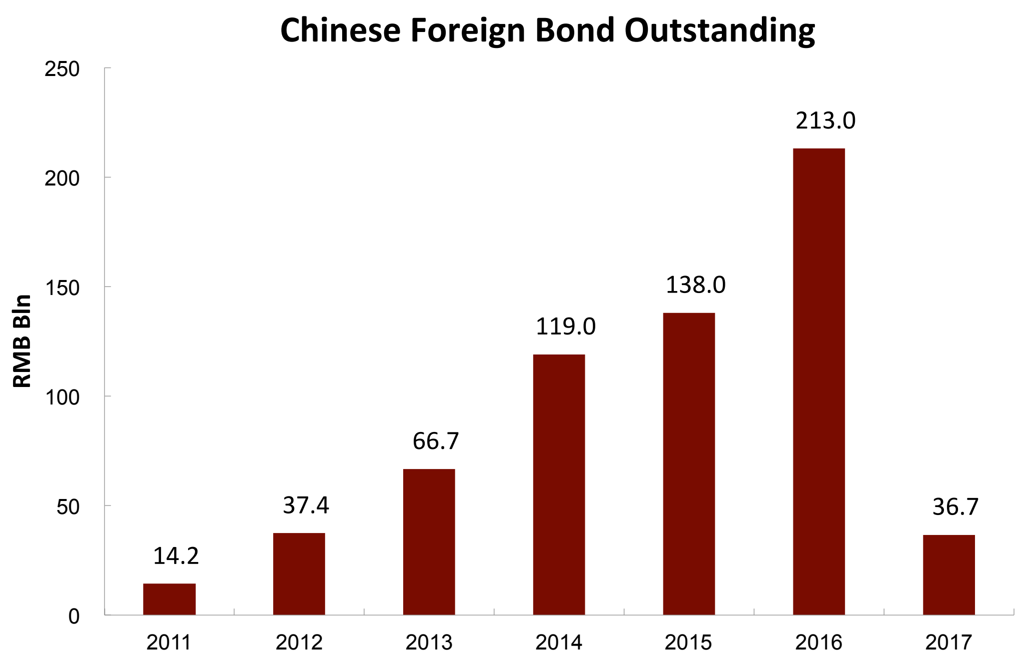


Foreign Bonds are Also an Unlikely Source of Funds

The same holds true for the ability of Chinese corporates to tap the foreign bond market. As is well known, China's corporates have borrowed heavily since 2009, spurred by the stimulus plan. Corporate debt as a percentage of GDP has risen from 102 percent in 2008 to 165% in 2015.



While much of this growth has come from domestic loans and bonds, foreign bond issuance has also been substantial, growing at a 73% CAGR from 2011 to 2016. Although 2017 has gotten off to a good start, with bond sales still high, this pace is unlikely to be sustained due to a) concerns about the RMB and b) unwillingness among corporates to increase interest rates.



The Real Target Is China's Liquid Foreign Reserves

What does this mean for the currency? If the PBOC cannot force the market to lend in foreign currency to corporates, what is the alternative? Burn through liquid reserves – which is what the PBOC appears to be doing. The PBOC has approximately $1.8 trillion in liquid assets that it can sell quickly. This includes $1 trillion in US Government Bonds, $200 billion in U.S. equities, and approximately $400 billion in Euro assets. Tracking the decline in these numbers would be an indicator of how quickly the reserves will decline – and more important, whether the PBOC eventually is forced to free float the currency.

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