Commentary on the BCI of January 2018

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In January 2018, CKGSB Business Conditions Index (BCI) was 55.5, which is lower than the index of 62.8 in December 2017. A very rare phenomenon in the BCI series of this month is that all the indices are falling, but it's a little bit different in the decreasing amplitude. It is still unknown whether this is the beginning of a trend, or whether it is an occasional data disturbance. However, such an extreme phenomenon deserves our attention.

In view of this month's data, the author has made the following two comments:

Firstly, the efforts of the Chinese government to rectify the finance have been initially successful. Recently, the data from two financial fields have aroused widespread concern in the market. The first is the new increment in the scale of social financing. Compared with November 2017, the new increment in the scale of China's social financing in December 2017 has declined sharply. In November 2017, the value was 1.6196 trillion RMB and it fell to 1.1398 trillion RMB in December. Compared with the new increment in the scale of social financing in December 2016, the data of December 2017 was also decreased by 30%. It is worth noting that the decline in December 2017 was mainly due to the decline in new RMB loans. Compared with November 2017, the figure of December was almost halved, from 1.1428 trillion RMB to 576.9 billion RMB. Compared with financing methods such as trust loans, entrustment loans and bank acceptance bills, RMB credit is more vulnerable to government policies. It is worth noting that the sharp decline in the data is obviously beyond market expectations. Economists surveyed by the *Wall Street Journal* had previously predicted that the amount of loan credit added in December would be about 965 billion RMB.

The second is the sharp decline in the speed of monetary growth. At the end of December 2017, the broad money supply (M2) increased 8.2% year-on-year. The growth rate was 0.9%, which was 3.1% lower than those at the end of last month and the same period of the previous year. There are two explanations for this data: Firstly, according to Wind's data, 8.2% has been the lowest since 1986 and the lowest since the data was recorded; secondly, since May 2017, M2 growth rate dropped below 10% for the first time in history and has gradually declined since then.

In fact, the change in the financial sector has already begun. According to reports by Xinhua News Agency on November 9th, 2017, "With the approval of the Central Committee of the Party and the State Council, the Committee for Financial Stability and Development of the State Council has been established and the first plenary meeting was held". The first director of the committee was Ma Kai, vice premier of the State Council. It was proposed at the National Conference on Financial Work held between July 14th and 15th, 2017, to establish the Committee for Financial Stability and Development of the State Council and to strengthen the responsibilities of macro-prudential management and systemic risk prevention of the People's Bank. By October 2017, Zhou Xiaochuan, the President of the People's Bank of China, publicly stated that in the future, the Committee for Financial Stability and Development of the State Council will focus on four major aspects: shadow banking, asset management industry, Internet finance and financial holding companies.

After the foundation of China Banking Regulatory Commission (CBRC) in 2003, the pattern of “one bank and three commissions” (The People’s Bank of China, China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission (CIRC) and CBRC) has been formed in the field of China's financial regulation, which is a system of separate supervision. Since then, great changes have been made in Chinese finance, which can be reflected in two aspects. The first aspect is the rise in scale. Taking the total assets of financial banking institutions as an example, this figure was nearly 28 trillion RMB in 2003. By November 2017, the data had risen to 244 trillion RMB, with an average annual growth rate of 18%; the second aspect is the change in structure. According to the data from the Central Bank, namely the People’s Bank of China, at the end of 2016, the asset management business of China's financial institutions was about 102.1 trillion RMB, the pattern that asset management business can compete with traditional credit was formed and particularly, the financial balance of bank products has been increasing at an alarming rate. At the end of 2016, the balances of on-balance-sheet and off-balance-sheet in financing bank products were 5.9 trillion RMB and 23.1 trillion RMB respectively, while the balance of financing bank products was only hundreds of billions of RMB in 2005.

The development of asset management business has made the financial sector more and more integrated, which has produced more contradictions with the current mode of separated supervision of different sectors. On one hand, the rapid development of assets management industry has brought more benefits to investors, many of whom are past savers, and it has facilitated the process of interest rate marketization; on the other hand, it has brought more risks. For example, there are some problems in bank financial products, such as operation model of asset pool and opacity, maturity mismatch, and the breakdown of rigid payment is a distant prospect. If these problems are not solved in time, it is bound to cause the accumulation of systemic risk in the financial field.

The Committee for Financial Stability and Development is currently established at the State Council level and is chaired by a deputy prime minister, which is obviously to break the connection of different sectors among “one bank and three commissions”. One thing that caught my attention was the name of the committee--the Committee for Financial Stability and Development. Note that stability is placed before development. This is not an unintentional move.

In addition to the field of financing, the government has also started to reduce financial risk in the field of investment. For example, Baotou has called a halt to local subway construction projects. According to media reports, Baotou’s metro project started in May 21st, 2017, with an investment of over 30 billion RMB. It is the infrastructure project with the single largest investment in local history. However, the local finance was tight and the project would generate more than 20 billion RMB in bank loans. On one hand, it was far beyond the ability of local finance to repay; on the other hand, it would greatly increase the debt risk of financial institutions. The situation attracted the attention of the central government, which eventually called a halt to the construction of the project after its six-month construction.

Besides ending the construction of Baotou’s metro, the central government has taken several measures to reduce local infrastructure projects. This is necessary for the prevention and control of financial risks, because local governments will not go bankrupt, so they dare to borrow regardless of cost. If this problem cannot be solved, strengthening supervision in the financial sector will be less effective. It's just like holding water in a pool, opening the tap to release water into it, but failing to plug the leak.

Secondly, the rise of the leverage ratio of the resident sector deserves our attention in the regulation of real estate. In the debate over real estate, there are some conflicting views, such as whether prices will continue rising. However, there is a consensus that real estate has a very important impact on the Chinese economy. According to some points of view, if the upstream and downstream industries such as steel, cement, furniture and household appliances were added, the output value of real estate industry would account for about 20% of the total GDP.

In addition, the impact of real estate on government income is obvious. Land finances now adopt the general operation mode of local governments, which has increased the revenues of local government and provided more money to invest and accelerate the local economic growth. However, in the process, a lot of lands are mortgaged to banks to get loans, and many of the payments come from future land transfers. Thus, if house prices and land prices fall, it is likely that the risk will be transferred to banks. More importantly, the real estate industry has also obtained a lot of money from shadow banks, which further increases the risk of the whole financial system.

For these reasons, the government often leaves real estate regulation unfinished, which has led to higher prices and rising expectations on the increase of house prices. After 2016, house prices began to rise again with the relaxation of real estate regulation. As a result, the amount of newly added medium and long-term loans (mainly mortgage loans) also soared, such that the proportion of the total amount of new RMB loans also rose. In 2016, there were 9 months in which the value exceeded 40%, and the proportion reached 103% during the peak (loans from other sectors have been reduced, so more than 100% will appear). The situation has eased since 2017, but the figure has been more than 40 percent for six months, the overall figure of all months has exceeded 30% and the maximum proportion was 53% in December 2017. According to Wind's data, such a situation is unprecedented.

The result of the rapid growth in mortgage loans is the rapid rise in the household sector's leverage ratio. According to the data from the Bank for International Settlements, the proportion of total debts held by residents and Households and Non-Profit Institutions Serving Households (NPISHs) in GDP was 38.8% at the end of 2015. By the end of June 2017, the proportion was 46.8%, which is an increase of 8%. During the same period, the total rose by 5.7% in all emerging markets and rose by 3.2% in all reported countries.

After the central government put forward its point of view that "Houses are for living, not for speculation", the real estate regulation policy of local governments has not been eased, but new mortgage loans still occupy a large proportion of the bank loans. In the past, we often said that China's leverage ratio has been rising rapidly over more than a decade, but the situation in the residential sector has been relatively good. According to the data from the Bank for International Settlements, the leverage ratio of the residential sector has also increased rapidly. For example, at the end of March 2006, the proportion of the total debts held by residents and NPISHs in GDP was

11.5%, which was 35.3% less than the 46.8% in June 2017.

In some sense, the leverage addition of resident sector is actually reducing leverage for other sectors. However, this move can get the resident sector more deeply involved in the battle of keeping house prices. If house prices fall, the open and local governments may be unable to bear it, and the residents who have mortgages may not be able to bear it, which, in turn, increases the financial and fiscal risks. From this point of view, the current real estate regulation cannot be eased as it used to be, but the leverage ratio of the resident sector can be further improved. It will become difficult if “the bottom line of systemic financial risk is not kept”.

These are the author’s comments on the BCI statistics for January 2018. For more inquiries, do not hesitate to contact the BCI team through the e-mail addresses provided in the January BCI data report.

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