Chi Time

UNCERTAINTY, RISK AND DILEMMA OF DELEVERAGING CHINA

In this world nothing can be said to be certain, except death and taxes.

Benjamin Franklin

Contrary to the view that Beijing is kicking the can down the road, it has started a debt-reduction process by selective monetary and regulatory tightening measures. These include two small (10 bps) rate hikes in the interbank market, selective property market tightening measures, slowdown in fiscal spending and a series of regulatory measures to curb bank loans to non-bank financial institutions (NBFIs).

The reason to use a selective tightening approach is not to slam the brakes on conventional credit creation but to reduce regulatory arbitrage and rent-seeking by the less-regulated entities, including insurance companies, brokerage houses and investment funds. Macroeconomic policies have been reserved for countering any unexpected growth decline during the deleveraging process.

The regulators have also identified the major financial risks in the system and ordered the banks to improve risk management. The caveat is that there is no incentive scheme to change their rent-seeking behaviour. So the impact of the deleveraging effort is uncertain. More regulatory tightening to force debt reduction, as Beijing seems determined to do, may risk policy overkill that could hurt domestic economic growth and asset prices.

While the regulators are under pressure to contain financial risk, their hands are also tied by the growth protection directive from Beijing. This puts them in a policy dilemma that could make the debt-reduction effort fall short of expectations and, thus, create market volatility.

Deleveraging by regulatory forces

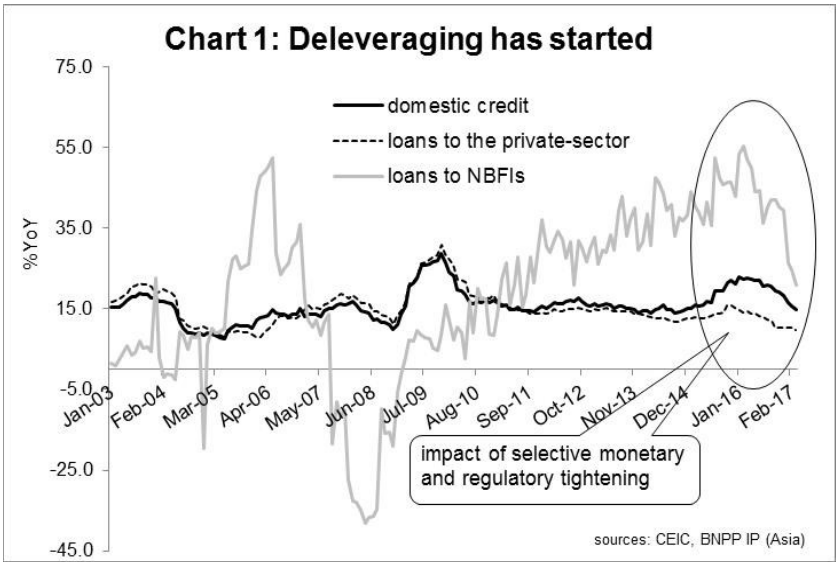
China's resolve to reduce debt can be seen from the PBoC's persistence to use the nascent economic recovery as a cushion to squeeze financial excess through small "surgical" tightening and implementation of the Macro Prudential Assessment (MPA) framework since 1Q 2017[1]. The coordinated push for tougher financial regulations since March this year by all the regulators (CBRC, PBoC, CSRC and CIRC) builds on the MPA's supervisory force to pare financial excess. It focuses on reducing regulatory arbitrage activities by both banks and NBFIs and the multi-layer lending irregularities that they have created[2].

Crucially, the key regulatory measures aim at breaking up the network that increases systemic risk and channelling more credit to the real economy. They do so by ordering banks to self-assess and report their regulatory, interbank and related-party arbitrage activities[3] and other irregularities as detailed in a long list, and disclose whether they have used interbank funding to expand their balance sheets and investment in the capital market.

The uncertainty, risk and policy dilemma

All this sounds good, but the effectiveness of these efforts remains uncertain. While the banks are given detailed checklists for self-assessment and reporting, there is no incentive scheme to correct their rent-seeking behaviour. There is not even any announcement on the consequences that the banks will face if they violate the guidelines. What is clear is that financial arbitrage and irregularities are a system-wide problem in China.

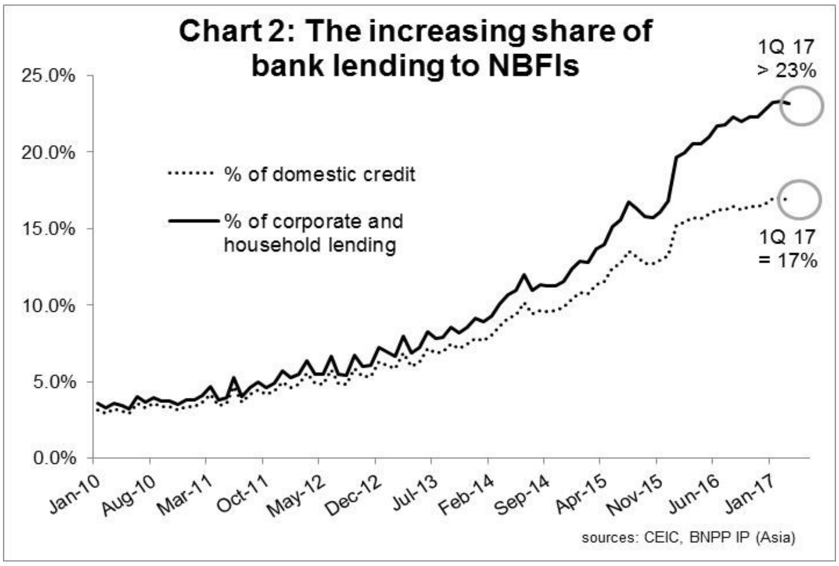
Without a proper incentive scheme to change the banks' behaviour, the regulatory tightening can only reduce financial excess by squeezing liquidity in the system. Indeed, the combination of regulatory tightening and the PBoC's small "surgical" rate hikes has already crimped credit growth, led by the sharp fall in bank lending to NBFIs since late 2016 (Chart 1). The share of bank lending to NBFIs has risen to the extent that it is no longer a marginal part of the financial system (Chart 2). Hence, continued regulatory tightening on such lending could reduce credit growth further even without outright monetary tightening.



[1] See "*Chi on China: What We Don't See in China's Debt Risk?"* 10 May 2017.

[2] See "*Chi on China: Where Does China's Financial Risk Lie?*" 23 November 2016.

[3] Under the CBRC definitions, regulatory arbitrage is defined as changing the regulatory form but not in substance of a financial transaction; interbank arbitrage refers to transactions that unnecessarily lengthen the credit creation process by moving funds around different financial institutions; and related-party arbitrage refers to using transactions with associated firms to circumvent regulatory controls.



Here lies the risk to the economy. The increase in multi-layer lending between financial institutions has masked the flow of the underlying credit to the real economy. About two-thirds of the NBFI loans have gone to the real economy as shadow finance, amounting to 11.3% of total domestic credit. Cutting these shadow credit links also cuts funding to the real (and new) economy. A cold comfort is that an increase in official credit to the real economy that the regulatory effort is designed to divert should limit such negative impact on GDP growth.

However, the impact on the domestic asset market could be large. The rest of the one-third (or RMB9.3 trillion in 1Q 17) of the NBFI loans has been invested in domestic stocks and bonds. But this segment of lending is precisely what the regulators are aiming at cracking down. Strict enforcement of the new tightening rules could potentially lead to sharp and disorderly unwinding of interbank positions and NBFI investment, creating a liquidity squeeze that could hurt the domestic asset market and even the economy.

Hence, the regulators are under pressure not to go too far and trigger a financial sell-off and an economic slump. Nevertheless, these regulatory measures are a reminder that China has other tools for adjusting the pace of credit and GDP growth than just interest rates. In the short-term, Beijing will likely continue to rely on regulatory tools to force deleveraging in selective areas rather than rely on conventional monetary policy to force overall deleveraging. Small banks and NBFIs will remain the targets of deleveraging since regulations have been lagging behind their fast rate of expansion. It is normal for the regulatory crackdown on leverage to cause some market volatility, which should be seen as a cost to acting early to curb the risk of financial irregularities.

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