CHINA ECONOMICS WEEKLY

China has its own banking sector vulnerabilities

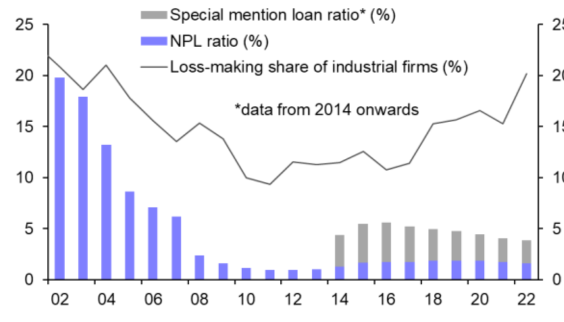
China's financial system has limited direct exposure to foreign banks. But recent global banking strains still pose some downside risk to the country's economy. While there are signs that the situation is stabilising, it's too early to rule out a wider tightening in global financial conditions. That would weaken the outlook for China's exports and the ability of its firms to access offshore financing – external debt is low relative to GDP but it is concentrated in a few key areas such as real estate development.

The hit to growth from such an external shock could be offset with policy easing. But officials have become increasingly conscious of the trade-off between stimulus and medium-term financial risks. With this in mind, the National People's Congress, which concluded on Monday, signalled a relatively cautious approach to policy support.

This restraint partly stems from the fact that China's banking sector has vulnerabilities of its own. These are different in nature and urgency to those in the US and Europe but they nonetheless deserve attention. The problem in China has less to do with market risk – domestic interest rates have risen far less than elsewhere – and more to do with credit risk. China's debt-to-GDP ratio has soared from 140% to 295% since 2008, with bank lending to corporates making up much of the increase. Such rapid rises in leverage are typically associated with a deterioration in lending standards and, ultimately, a rise in NPLs.

Bank balance sheets are already under pressure due to last year's downturn. The sharp slowdown in GDP growth was in line with what the PBOC had assumed in the "severely adverse scenario" of its 2021 banking sector stress test. At the time, it estimated this would push the NPL ratio above 7%. On paper, it has remained below 2%. But that is implausible given wider evidence of growing financial strains – bond defaults jumped last year and the loss-making share of industrial firms rose to an 18-year high of 20%, a level last seen when the reported NPL ratio was 13%. (See Chart 1.)

Chart 1: Loan Impairment & Loss-making Firms



Sources: CEIC, Capital Economics

Banks have used a combination of accounting tricks and securitisation to conceal NPLs. But that hasn't prevented rising bad debt from weighing on bank profitability. This is especially true among regional banks, who have seen their return on assets fall to just 0.5%, from 1.5% less than a decade ago.

The rebound in economic activity that is underway should slow the rise in bad debt. But it will still leave many banks in a precarious position. Even before last year's downturn, 289 regional banks were considered high-risk by the PBOC.

A handful of regional banks have already run into problems in recent years. More will surely follow. Provided that the government continues to step in to protect bank creditors from losses, then problems at individual banks need not trigger a wider crisis. But the risk is that policymakers, seeking to reduce moral hazard, attempt to dismantle the state backstop.

That could lead to wider contagion, triggering a sharp repricing of counter-party risk and a liquidity crunch. Our sense is that in such a scenario policymakers would quickly back down and restore state support, avoiding a full-blown financial crisis. But plenty of damage could be done in the interim. And the risk of a policy misstep is rising in tandem with the pile of bad debt.

The week ahead

Despite the cut to banks' reserve requirement ratios announced today, we don't think the PBOC will adjust the Loan Prime Rate next Wednesday.

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Data Previews

Loan Prime Rate (Mar.)

Wed. 20th Mar.

Forecasts	Time (China)	Previous	Consensus	Capital Economics
Loan Prime Rate (1-year)	09.15	3.65%	3.65%	3.65%

Rate cuts are no longer a priority

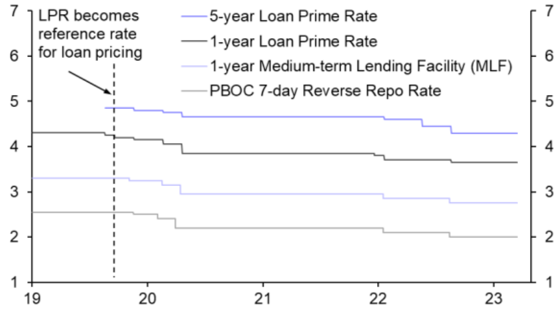
The PBOC has left its policy rates untouched since last August, when it reduced the 1-year Loan Prime Rate (LPR) by 5bps. (See Chart 2.) We think the central bank will remain on hold this month.

The PBOC refrained from changing the interest rate on its medium-term lending facility (MLF) earlier this week, typically a precursor to adjustments in the Loan Prime Rate (LPR). Admittedly, the central bank has since announced a 25bps cut to banks' required reserve ratios (RRR). But some previous RRR reductions, including the most recent one in December, were not followed by policy rate cuts.

Having kept rates on hold throughout the winter downturn, it's unclear why the PBOC would resume cuts now, when the economy is already in the midst of a rapid recovery. And the National People's Congress (NPC) signalled a relatively restrained policy stance this year, with the focus shifting towards defusing financial risks.

To the extent that monetary policy is eased further, the NPC reports suggest that this will be done in "a targeted way". That points toward a preference for non-conventional tools such as re-lending facilities, which have grown in importance in recent years.

Chart 2: Policy Rates (%)



Sources: CEIC, Capital Economics

Economic Diary & Forecasts

Upcoming Events and Data Releases

Date	Country	Release/Indicator/Event	Time (China)	Previous*	Median*	CE Forecasts*
March						
Mon 20th		**Chn** 1-Year Loan Prime Rate (Mar.)	(09.15)	3.65%	3.65%	3.65%
Thu 23rd		**HK** Consumer Prices (Feb.)	(16.30)	(+2.4%)	-	(+2.2%)

Selected future data releases and events:

March

Mon 27th		**Chn** Profits of Large Industrial Firms (Feb., ytd y/y)
Fri 31st		**HK** Trade Data (Feb.)
		Chn "Official" PMIs (Mar.)
		HK Retail Sales (Feb.)
		Chn Current Account Balance (Q4, Fin.)

Also expected during this period:

TBC		**Chn** CBRC Data on Assets and Liabilities of Financial Institutions (Feb.)

Main Economic & Market Forecasts

%q/q annualised (%y/y), unless stated	Latest	Q1 2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	2022	2023f	2024f
Official GDP	0.0(+2.9)*	(3.4)	(7.6)	(5.1)	(6.4)	(5.6)	(3.0)	(5.5)	(5.0)
GDP (CE CAP-derived estimates)	-2.6(-5.9)*	(-0.9)	(7.2)	(5.9)	(10.3)	(6.7)	(-2.4)	(5.5)	(5.0)
Consumer Prices	(+1.0)**	(2.8)	(2.1)	(2)	(2.2)	(2)	(2.0)	(2.4)	(1.6)
Producer Prices	(-1.4)**	(-1.2)	(-3)	(-0.7)	(0.1)	(0.1)	(4.1)	(-1.0)	(0.5)
Broad Credit (AFRE)	(+9.9)**	(9.1)	(9.2)	(9.8)	(10.4)	(10.4)	(9.6)	(10.4)	(9.2)
Exports (US$)	(-6.8)***	(-14.2)	(-16.4)	(-18.3)	(-8.4)	(-1.2)	(7.0)	(-14.5)	(0.0)
Imports (US$)	(-10.2)***	(2.9)	(-3.4)	(-8)	(1.2)	(1.2)	(1.1)	(-2)	(3.5)
RMB/$†	6.90	6.90	6.90	6.80	6.70	6.65	6.95	6.70	6.50
7-day PBOC reverse repo† %	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
1-year Loan Prime Rate† (LPR) %	3.65	3.65	3.65	3.65	3.65	3.65	3.65	3.65	3.65
1-year MLF Rate† %	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75
10-year Government Bond Yield† %	2.88	2.80	2.70	2.90	3.10	3.10	2.85	3.10	3.10
RRR (major banks)† %	10.75	10.75	10.75	10.75	10.75	10.75	11.00	10.75	10.75
CSI 300 Index†	3,939	4,000	4,250	4,550	4,770	4,850	3,872	4,770	5,110
Hong Kong GDP	(-4.2)*	(1.5)	(2.3)	(7.4)	(9.8)	(9.5)	(-3.5)	(5.5)	(9.5)
Hang Seng Index†	19,204	19,500	21,750	24,000	26,000	26,375	19,781	26,000	27,500

Sources: Bloomberg, Refinitiv, CEIC, Capital Economics *Q4; **Feb.; ***Jan. & Feb., † End of period