CHINA ECONOMICS WEEKLY

Shadow banks are getting squeezed

But they aren't as big a systemic threat as some fear

In addition to troubles at Country Garden, the big story in China's credit markets this week was the turmoil at Zhongzhi. Yesterday, the asset manager cum shadow bank acknowledged that it was in a liquidity crisis and took the first steps toward a restructuring. This highlights the growing pressure on non-bank financial institutions (NBFIs), many of which are suffering from losses on their investments in the property sector – which makes up at least 8% of trust loan portfolios.

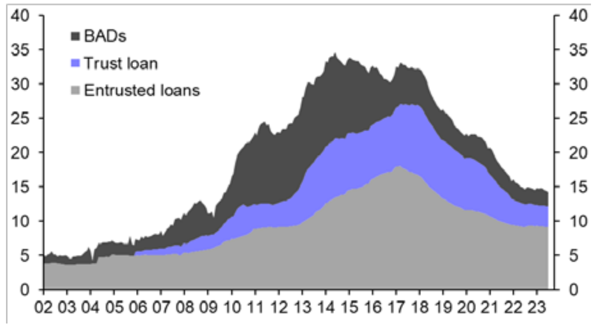
In the past, they might have been able to conceal these losses and continue to meet payments with the help of fresh funds from new investors. But those inflows are drying up. Households and corporates have become increasingly cautious, shifting their money out of risky investments managed by NBFIs and into the safety of bank deposits and government bonds. Issuance of wealth management products during the first half this year was the weakest since at least 2013.

This combination of mounting losses on their assets and outflows on the liability side is a recipe for further NBFI failures – Zhongzhi won't be the last to run into trouble. The key question though is whether this poses a systemic threat. For now at least, our sense is that it is a manageable problem.

The importance of NBFIs in China's financial system has diminished in recent years due to a series of regulatory crackdowns that have shrunk the sector. Its assets have declined from a peak of 92% of GDP in 2016, to 53% in 2021. The same ratio is well over 100% of GDP in most developed economies. The bulk of the assets held by Chinese NBFIs are relatively safe – 40% of the total are government and bank bonds, another 31% are bank deposits.

There are some areas of concern, such as exposure to developer bonds (the scale of which is unclear) and the 15% or so of GDP in outstanding shadow credit. (See Chart 1.) But this shadow credit isn't all linked to NBFIs – entrusted loans are generally extended by non-financial firms for example. And there are few signs in the interbank market of any contagion from the Zhongzhi news. The premium that NBFIs pay compared to banks remains low.

Chart 1: Shadow Credit Outstanding (% of GDP)



Sources: CEIC, Capital Economics

To the extent that NBFIs go under, their creditors can probably take the hit. Commercial bank lending to NBFIs only represents 0.4% of their loan books. The bulk of NBFI funding comes from relatively wealthy individual investors or corporates with cash to spare.

One could argue that NBFI failures are the canary in the coal mine, signalling a wider deterioration in asset quality across the financial system, including the much more systemically important banks.

That's true in a narrow sense. But most banks are better placed to absorb losses and stay afloat than NBFIs. For a start, they aren't suffering the same liquidity strains. To the contrary, they are benefiting from the shift into deposits. And state backing means that their asset quality doesn't have much bearing on their ability to raise capital at a low cost or access cheap wholesale funding.

To be sure, the economic downturn is putting a great deal of strain on financial sector balance sheets, and it does increase the risk of a messy policy mistake if officials don't handle the situation with care. But we still think a full-blown financial crisis is a tail risk rather than a probable outcome.

The week ahead

The Loan Prime Rate is set to be lowered on Monday and we'll be keeping an eye out for any wider stimulus announcements.

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Data Previews

Mon. 21st Aug. – Loan Prime Rate (Aug.)

Forecasts	Time (China)	Previous	Consensus	Capital Economics
Loan Prime Rate (1-year)	09.15	3.55%	3.43%	3.40%
Loan Prime Rate (5-year)	09.15	4.20%	4.05%	4.05%

Another cut assured following policy rate reductions

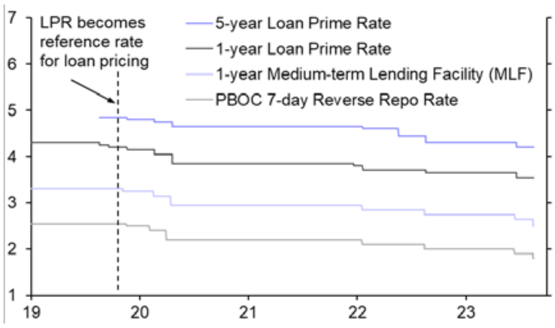
The PBOC lowered its 1-year Medium-term Lending Facility (MLF) rate from 2.65% to 2.50% on Tuesday, marking the largest cut since the initial pandemic hit. It also cut its 7-day reverse repo rate, the main rate at which it provides short-term liquidity to banks, from 1.90% to 1.80%. Both were the second cuts within three months. (See Chart 2.)

The Loan Prime Rate (LPR) is set by adding a mark-up to the MLF rate. Therefore, reductions are pretty much a given. We expect a 15bps cut next Monday to both 1-year and 5-year LPRs.

These reductions will lower the cost of new loans, as well as interest payments on existing loans (although not always immediately). This should provide some modest support to economic activity.

But we think it is unlikely to lift credit growth much, given the drag on loan demand from reduced confidence in the economic outlook.

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*
August						
Mon 21st	Chn	1-Year Loan Prime Rate (Aug.)	(09.15)	3.55%	3.43%	3.40%
	Chn	5-Year Loan Prime Rate (Aug.)	(09.15)	4.20%	4.05%	4.05%
	HK	Consumer Prices (Jul.)	(16.30)	(+1.9%)	(+1.9%)	(+1.7%)
Thu 24th	HK	Exports (Jul.)	(16.30)	(-11.4%)	-	(-9.0%)
	HK	Imports (Jul.)	(16.30)	(-12.3%)	-	(-5.5%)
	HK	Trade Balance (Jul., HKD)	(16.30)	-56.6bn	-	-56.6bn

Selected future data releases and events:

August

Sun 27th — **Chn** Profits of Large Industrial Firms (Jul.)

Thu 31st — **Chn** "Official" PMIs (Aug.)

— **HK** Retail Sales (Jul.)

September

Fri 1st — **Chn** Caixin Manufacturing PMI (Aug.)

Also expected during this period:

TBC — **Chn** Trade – Detailed Breakdown (Jul.)

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

Main Economic & Market Forecasts

%q/q annualised (%y/y), unless stated	Latest	Q3 2023	Q4 2023	Q1 2024	Q2 2024	2022	2023f	2024f	2025f
Official GDP	+0.8(+6.3)*	(3.9)	(4.9)	(3.9)	(4.2)	(3.0)	(5.0)	(4.5)	(4.0)
GDP (CE CAP-derived estimates)	+2.5(+11.3)*	(4.7)	(7.7)	(5.2)	(3.4)	(-3.4)	(6.5)	(4.0)	(2.5)
Consumer Prices	(-0.3)**	(-0.2)	(0.0)	(0.9)	(1.0)	(2.0)	(0.5)	(1.0)	(1.0)
Producer Prices	(-4.4)**	(-2.9)	(-2.6)	(-2.2)	(-1.0)	(4.0)	(-3.0)	(-1.5)	(-0.5)
Broad Credit (AFRE)	(+8.9)**	(10.0)	(10.8)	(9.5)	(9.3)	(9.6)	(10.8)	(8.9)	(8.3)
Exports (US$)	(-14.5)**	(-16.0)	(-5.5)	(-10.0)	(-4.0)	(7.0)	(-8.0)	(-3.0)	(2.5)
Imports (US$)	(-14.5)**	(-11.0)	(-3.0)	(15.5)	(6.5)	(1)	(-7)	(7.5)	(1.5)
RMB/$†	7.29	7.05	6.90	6.80	6.70	6.95	6.90	6.50	6.40
7-day PBOC reverse repo† %	1.80	1.70	1.60	1.60	1.60	2.00	1.60	1.60	1.60
1-year Loan Prime Rate† (LPR) %	3.55	3.30	3.20	3.20	3.20	3.65	3.20	3.20	3.20
1-year MLF Rate† %	2.50	2.40	2.30	2.30	2.30	2.75	2.30	2.30	2.30
10-year Government Bond Yield† %	2.57	2.50	2.40	2.50	2.60	2.85	2.40	2.60	2.60
RRR (major banks)† %	10.75	10.50	10.25	10.25	10.25	11.00	10.25	10.25	10.25
CSI 300 Index†	3,831	3,820	3,800	3,900	4,000	3,872	3,800	4,200	4,900
Hong Kong GDP	(+1.5)*	(7)	(10.5)	(7)	(10.5)	(-3.5)	(5.5)	(9)	(6)
Hang Seng Index†	18,326	18,300	18,250	23,940	24,875	19,781	18,250	23,000	26,750

Sources: Bloomberg, Refinitiv, CEIC, Capital Economics *Q2; **Jul.; † End of period

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