CAPITAL ECONOMICS 凯投宏观

CHINA ECONOMICS UPDATE

Five takeaways from the Financial Work Conference

- **China's leadership has outlined its wish list for financial sector development. It wants stricter oversight of financial institutions to ensure they serve the interests of the Party and country. This includes providing greater credit support to struggling firms, such as private property developers, and channelling more funds to strategically important industries. Policymakers also appear to be getting more serious about addressing the risks associated with regional banks and local government financing vehicles.**

- Top officials gathered in Beijing this week for the Financial Work Conference. This is held twice a decade to outline priorities for financial sector development over the coming five years. The meeting is held behind closed doors. But an official readout was published by state media late yesterday. As is typical for such high-level meetings, the readout was light on specifics and didn't contain any major surprises. But it did set a clear overall direction for financial regulation. In our view, there were five key takeaways:

- **Party control and oversight of the financial sector will be tightened.** The meeting readout made it clear that the leadership is not satisfied with the current state of financial regulation. It noted that "*hidden economic and financial risks are still widespread, the quality and efficiency of financial services for the real economy is not high, financial disorder and corruption continues to occur, and financial supervision and governance capacity is weak"*. To address this, the meeting called for greater "purity" and professionalism among the financial workforce. It also stressed the importance of the financial sector *"adhering to the centralized and unified leadership of the CPC Central Committee"*. The implicit message is that financiers should strive to serve the interests of the Party and the country, rather than focus narrowly on financial returns and personal gain. Financial institutions and their staff are likely to be more closely scrutinised to make sure they align with this top-down guidance.

- **In particular, regional banks look set to be more stringently regulated.** A number of these institutions have run into trouble in recent years, in some cases resulting in bank runs and brief bouts of social instability. These problems have their origins in the rapid expansion of regional bank balance sheets, fuelled by growth in the wholesale funding market and by the digitization of banking services, which facilitated inter-region deposit and lending flows. The leadership intends to curb such growth in future, vowing to *"strictly enforce market access standards and regulatory requirements for small and medium-sized financial institutions*" and calling on them to refocus on localised operations. At the same time, it wants to strengthen the role of the large state-owned banks as the main ballast of the financial system.

- **More lending will be directed to areas of strategic interest.** One way in which the leadership wants the financial sector to better serve the interests of the state is by channelling more funds toward *"scientific and technological innovation, advanced manufacturing, green development and SMEs"* as well as efforts to *"ensure national food and energy security"*. This push has been underway for some time and is starting to have an effect. There are pros and cons to this approach. On the one hand, it can help to overcome market failures that would otherwise result in underinvestment in areas that have positive externalities, such as green technologies. But on the other hand, allocating credit based on political priorities instead of market signals has a mixed track record in China and has often resulted in malinvestment and excess capacity. This could add to the financial risks surrounding bad debt rather than reduce them.

Julian Evans-Pritchard, Head of China Economics, julian.evans-pritchard@capitaleconomics.com

- The current health of local government financing vehicles (LGFVs) underscores this point. They have helped to build out China's infrastructure and served the agenda of local officials but at a financial cost – few of them are able to repay their debt without help from subsidies. And with local governments increasingly stretched themselves, many LGFVs are at risk of default.

- **The leadership is getting more serious about resolving local government debt risks.** The meeting readout included a pledge to "establish a long-term mechanism for preventing and resolving local debt risks" and to "optimize the debt structure of central and local government debt". This suggests that officials are coming around to our view that a market-based resolution to LGFV debt isn't feasible and that greater government intervention is required. A lasting fix would involve formally recognising more LGFV debt as public debt and shifting more of the burden of deficit spending from local to central government.

- **Private developers will be extended more credit support.** Although policymakers remain reluctant to provide outright bailouts to private developers, they have been trying to stem some of the bleeding with credit support. But lenders have so far been slow to play their part in these efforts. Banks have utilised just 3% of a PBOC relending facility introduced late last year, which offered them RMB200bn in interest-free funding provided it was lent on to developers for use finishing existing projects.

- With the property sector still in the doldrums, the leadership seemingly wants banks to do more. In particular, the meeting called on them to *"satisfy the reasonable financing needs of real estate enterprises of different ownership systems without discrimination"*. This alludes to the fact that financing to state-owned developers is still flowing, while it has mostly dried up for private developers. This discrimination is rational from a credit risk perspective, not least because homebuyers themselves have become a lot more picky about who they purchase new homes from, favouring state-owned developers. But as the meeting readout notes, banks in China are expected not only to protect their bottom line but also to *"enhance their political perspective, keeping the nation's broad interests at heart"*.

- There is no guarantee that stepped-up efforts to support lending to private developers will succeed. China has a well-established history of using directed lending schemes, but they have had mixed success at best. At the level of individual banks making lending decisions, the commercial incentives to channel loans to state-owned firms with lower credit risk are still powerful. A lot will depend on the degree of political and regulatory pressure used to encourage banks to comply.

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