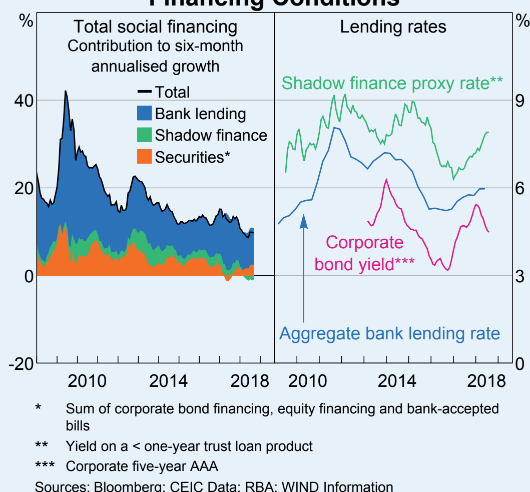
Box A

Evolving Financial Conditions in China

The Chinese authorities have long acknowledged that the growth of the financial system contributes to both the growth of economic activity and to the build-up of systemic risks.[1] Over the past couple of years, efforts to contain the build-up of systemic risks have increased.[2] These measures have successfully slowed the growth of overall total social financing (TSF), which declined to a decade-low earlier this year. Also, interest rates on bank lending, corporate bond financing and shadow financing rose and growth softened in some sectors of the economy.

Over the past year or so, Chinese regulators took a number of actions to encourage the rebalancing of TSF towards bank lending and capital market issuance, and away from shadow banking channels. This reflected the concern that shadow banking is subject to less stringent regulation and supervisory oversight than the banking sector, and makes use of complex and opaque structures. This can result in weaker lending standards, facilitate an excessive build-up of leverage, raise the number of interconnections between financial institutions, and reduce capital and liquidity buffers within the financial system. The authorities discouraged shadow financing by improving regulatory coordination across different agencies, introducing more stringent asset management regulations and restricting bank lending to the shadow banking sector. These actions have helped to constrain some of the key financing channels available for shadow banking activity.

In recent months, the Chinese authorities have responded to signs of slower growth in parts of the economy and a more challenging outlook by easing financial conditions in a number of ways. However, the effect of the current round of policy easing has been relatively small, including because it has been quite targeted. For instance, while the growth in TSF has picked up recently, to date this has been modest compared with earlier episodes (Graph A1). Moreover, this pick-up has occurred in the absence of a contribution from shadow financing. Indeed, a number of new regulations and even more stringent oversight have seen shadow financing contract.[3]



* Sum of corporate bond financing, equity financing and bank-accepted bills

** Yield on a < one-year trust loan product

*** Corporate five-year AAA

Sources: Bloomberg; CEIC Data; RBA; WIND Information

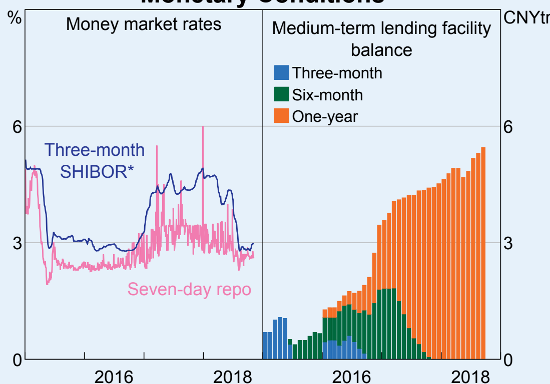
1 Lowe P (2018), 'Australia's Deepening Economic Relationship with China: Opportunities and Risks', Address to the Australia-China Relations Institute, Sydney, 23 May.

2 RBA (2018), 'Box A: Ongoing Financial Regulatory Reform in China', *Financial Stability Review,* October, pp 19–22.

3 Bowman J, M Hack and M Waring (2018), 'Non-bank Financing in China', RBA *Bulletin*, March, viewed 11 October 2018. Available at <https://www.rba.gov.au/publications/bulletin/2018/mar/non-bank-financing-in-china.html>.

The recent loosening in policies has focused on easing conditions for the banking sector, with an emphasis on the importance of banks increasing their lending to smaller private firms. The People's Bank of China (PBC) has ensured that banks have access to ample liquidity by cutting reserve requirement ratios and extending longer-term liquidity operations (such as the medium-term lending facility (MLF)). These measures have helped to guide money market rates to their lowest levels since late 2016 (Graph A2). The PBC has lowered the collateral requirements for assets that can be pledged against MLF funding to include highly rated corporate bonds, thereby encouraging banks to hold the bonds of small- and medium-sized firms. Banks have also been encouraged to use some of the funds provided by the PBC to support the debt-for-equity swap program, which aims to reduce the debt burden of companies in industries with excess productive capacity. These measures have also been complemented with 'window guidance', which is intended to directly influence bank lending.

Graph A2
Monetary Conditions



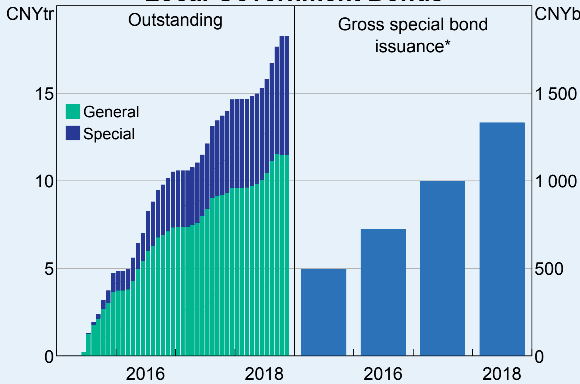
* SHIBOR is an average of the rate at which large banks say they will lend unsecured funds to other banks.

Sources: CEIC Data; RBA

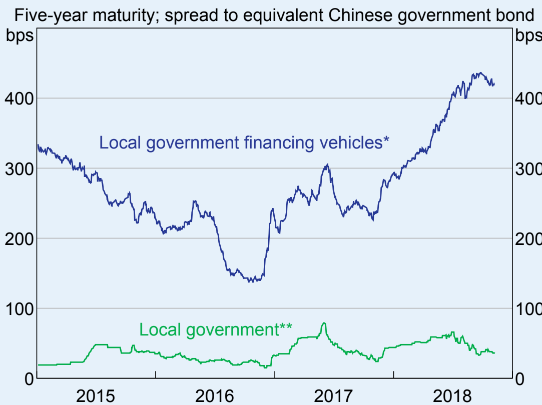
The Chinese authorities have also announced measures to encourage some borrowing by local governments, following concerns over the extent to which infrastructure spending had slowed. At the same time, the authorities have sought to improve the transparency of local government financing. In earlier years, a large share of local government spending had been funded via opaque off-balance sheet entities known as local government financing vehicles (LGFVs), which were widely assumed to benefit from implicit government guarantees. The proliferation of LGFVs followed restrictions on borrowing from banks during the lending boom in China that followed the global financial crisis. However, this 'back door' financing channel has more recently been actively discouraged by the Chinese authorities in favour of a more transparent 'front door' capital markets policy. After slow issuance earlier in the year, in August the Ministry of Finance directed local governments to accelerate their bond issuance over the remainder of the year. The Chinese banking regulator is reportedly also considering regulatory changes to encourage banks to purchase local government debt.

The measures taken, together with the easing in money market conditions this year, have supported local government bond financing. There has been a sharp increase in the issuance of 'special' (mostly project-based) bonds, the proceeds of which are supposed to finance specific infrastructure projects rather than general government expenditure (Graph A3). In coming quarters, this may support a rise in infrastructure investment, which has weakened sharply over the past year. Along with residential construction, infrastructure at times has made an important contribution to demand for Australian bulk commodity exports.

Recent changes in funding costs for local government should also facilitate a rebalancing in credit intermediation towards more transparent funding channels. Spreads on local government bonds have narrowed in recent months and remain at a low level, whereas



spreads on low-rated LGFV bonds have widened considerably (Graph A4). Investors have repriced the credit risk on low-rated LGFV bonds, in part reflecting efforts by the Ministry of Finance to eliminate perceptions of implicit government guarantees on LGFV debt.



Taken in sum, these developments suggest that the authorities continue to be mindful of financial stability risks, even as they look to the financial system to support infrastructure and overall economic activity in the coming quarters. ✠