# ASIA MONTHLY

# February 2018



株式会社日本総合研究所

http://www.jri.co.jp/english/periodical/asia/

# Topics China working to strengthen financial risk curbs

The Chinese government is beefing up its efforts to curb financial risk. This report takes a broad look at what kind of policies are being implemented and considers their effects, as well as looking toward the future.

## ■ Concerns over financing difficulties among small and medium sized banks

At China's 2017 Central Economic Work Conference, at which the country's economic policy framework is worked out, the issue of financial risk was raised, and policies aimed at curbing the growth of "total social financing", which indicates the volume of funding supply to the real economy, including shadow banking, were presented. The commercial banks' non-performing loan ratio has remained steady at the low level of 1.74% as of the end of September of 2017. Nevertheless, the concern over financial risk comes from an awareness of liquidity risk in the form of a cash flow crunch due to greater dependence on short term capital procurement, such as interbank markets and wealth management products, on the part of small and medium sized banks, typically joint stock commercial banks and urban commercial banks.

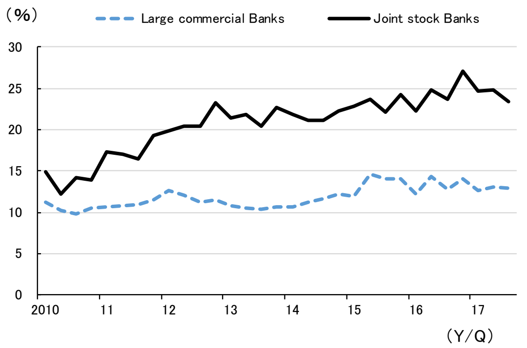
From 2016, China's central bank, People's Bank of China(PBC), introduced a monitoring system called "Macro Prudential Assessment" (MPA), in order to promote the sound management of the country's commercial banks. MPA assesses the commercial banks' balance sheets and lending under seven categories and, based on the result, determines the interest rate on the reserve deposits that the banks deposit with PBC. Since 2017, while the government, with the China Banking Regulatory Commission (CBRC) working to complement MPA, has been pushing the standardization of interbank market transactions, PBC has been trying to encourage small and medium sized banks to reduce their dependence on short term financing, through measures such as expanding the scope of MPA monitoring to include the fund management portion of non-balance sheet finance procured through sales of wealth management products.

＜MPA framework＞

| System of Assessment | | |
|---|---|---|
| | Area | Item |
| 1 | Capital and Leverage | Capital Adequacy Ratio(80),Leverage Ratio(20) |
| 2 | Assets and Liabilities | Broad Credit(60),Entrusted Loan(15),Interbank liabilities(25) |
| 3 | Liquidity | Liquidity Coverage Ratio(40),Net Stable Funding Ratio(40),Reserve Requirement Ratio(20) |
| 4 | Pricing | Market Based Pricing(100) |
| 5 | Assets Quality | NPL Ratio(50),NPL Coverage Ratio(50) |
| 6 | External Debt | Risk Weighted Balance(60),Currency Structure(20),Maturity Structure(20) |
| 7 | Credit Policy | Execution(70), Use of PBC Funds(30) |
| Assessment and Incentives | | |
| A | Fulfillment Rate (over 90%) | PBC raise interest rate of reserve deposit by 10～30% |
| B | Fulfillment Rate(60～90%) | PBC maintain interest rate reserve deposit |
| C | Fulfillment Rate(under 60%) | PBC cut interest rate of reserve deposit by 10～30% |

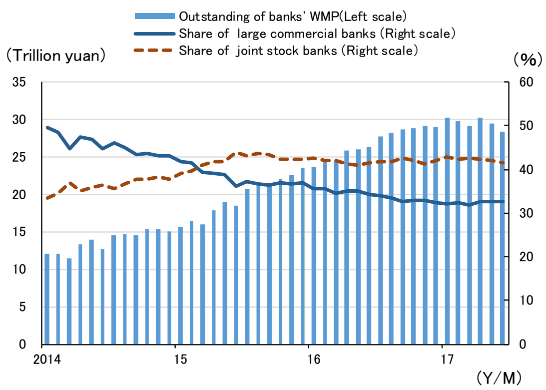
Note: Figure in parenthesis means weight in each items.
Source: JRI form local news

＜Degree of dependence in interbank money market＞




Note: Degree of dependence =Liability in interbank money market/ Total liability. Figure of Joint stock bank is weighted average of 7 banks data available.
Source: JRI from Bloomberg L.P.

＜Outstanding of Banks' wealth managment products(WMP)＞




Source: JRI from CEIC

The results are beginning to make themselves felt. Small and medium sized banks, which had been expanding their capital procurement in the interbank money market, have been reducing their dependence on that market since the start of 2017. In addition, the total for bank wealth management products created and sold by the banks stood at 28.4 trillion yuan at the end of June of 2017, down 1.9 trillion yuan from its peak in January of that year. The joint stock banks' decrease total was 1.2 trillion yuan, well above the 0.4 trillion yuan for the large commercial banks, and an indication that small and medium sized banks are beginning to cut back on the issue of wealth management products. However, the government feels that the effects have not yet been enough, and is still working out measures aimed at curbing financial risk.

## ■ Need for review of capital procurement structures

The following three are examples of policies that have been worked out recently in the hope of curbing financial risk. The first is the introduction of tougher restrictions on the interbank bond market. In China there is a growing number of small and medium sized banks that procure capital through the issue of negotiable certificates of deposit (NCD) in the interbank bond market. Concerned about this development, in September of 2017, PBC prohibited the issue of NCD that exceed one year, and announced that, from 2018, capital procured through NCD of a year or less by banks with assets in excess of 500 billion yuan would be included in the scope of MPA monitoring. Capital procurement in the interbank bond market is exclusively by small and medium sized banks, and it is expected that capital procurement through NCD by joint stock banks and top ranking urban commercial banks with assets in excess of 500 billion yuan will decline significantly.

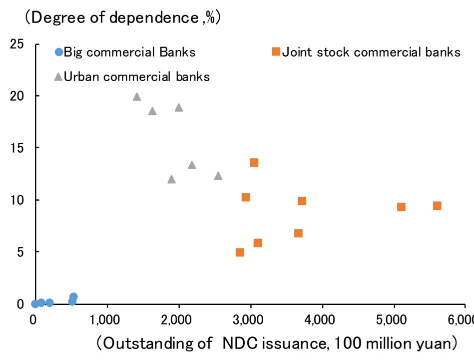
The second is the tightening of restrictions on wealth management products. In November, the government issued a set of draft guidelines on the tightening of regulations on financial institutions' asset management activities. The draft was issued jointly in the name of PBC, CBRC, China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission (CIRC) and the State Administration of Foreign Exchange, and is regarded as an indication of the government's intention to close off any loopholes in restrictions that may exist due to stove-pipe style administration, as well as to tackle seriously the work of the standardization of financial institutions' asset management business. Although the guidelines have a transition period that runs until June of 2019, the creation and sales of new wealth management products that violate the guidelines are prohibited, so it is expected that there will be a decline in capital procurement through wealth management products on the part of joint stock commercial banks that have a high degree of dependence on these products.

The third is the introduction of tighter liquidity risk management. In December, CBRC issued a set of draft rules on the liquidity risk management of commercial banks. The rules introduce the net stable funding ratio and liquidity coverage ratio discussed in Basel III, and are an attempt to increase risk tolerance. The rules mainly apply to banks with assets in excess of 200 billion yuan, and are due to come into effect from March of 2018. Banks with assets in excess of 200 billion yuan will include not only joint stock commercial banks and urban commercial banks but also top rank rural commercial banks, and banks with a strong dependence on short term capital will be forced to rethink their capital structures.

## ■ Deteriorating performance among short term capital-dependent small and medium sized banks

As a result of these measures, China is expected to make significant progress towards curbing financial risk. However, this does not necessarily mean that China will be on the path to sustainable, steady growth. If the business environment for banks, expecially small and medium sized banks, becomes more difficult, there may well be some banks that are unable to cope with the changes. Even though they all may be described as small and medium sized banks in a general sense, capital procurement structures can vary greatly from bank to bank. In terms of the degree of dependence on NCD as of June, 2017, this was between 4.9% and 13.5% for joint stock commercial banks, and between 12.0% and 19.8% for urban commercial banks, a very significant gap. The same phenomenon can be seen in the interbank money market and in wealth management products, and the risk of deteriorating business performance is higher for those banks that have a greater dependence on short term capital. It will be difficult to see risk curbing measures through at a single stroke, and the government will need to implement them cautiously, with consideration for the maintenance of financial order and the possible impact on the real economy.

＜Degree of dependence on NCD (June, 2016)＞



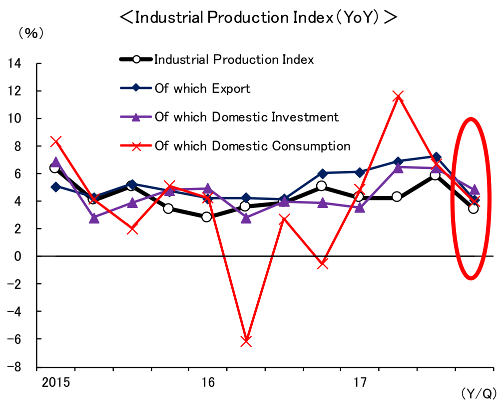

**(Yuji Miura)**

# Malaysia Focus on post election efforts to reform economic structure

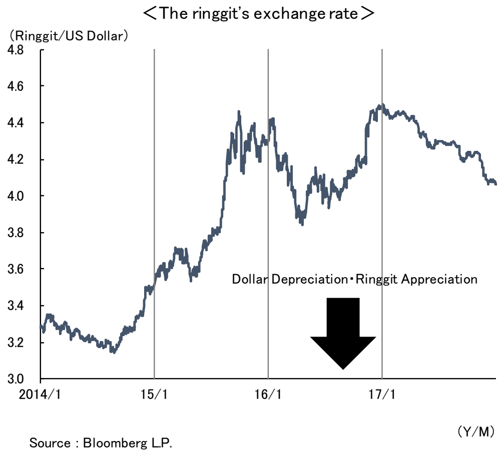
## ■ Lull in economic recovery

Malaysia's economy experienced a lull in the pace of recovery at the end of 2017. The industrial production index for October of 2017 grew 3.4% compared to the same period in the previous year, slowing from the July to September quarter (5.9%, compared to the same period in the previous year).

Viewed in more detail, both domestic and foreign demand performed poorly. Export growth slowed from 7.2% year on year growth in the July to September quarter to 4.1% growth, similarly. This is believed to have been in recoil from the export growth spurt that was seen from the end of 2016. Looking at export growth on an individual industry basis, industries such as electronic and electrical equipment manufacturing, which were the export growth drivers until the July to September quarter, lost their growth momentum.




Source: Department of Statistics Malaysia, Bank Negara Mlalaysia
Note: The data of 2017/4Q is Octorber 2017.




Source : Bloomberg L.P.

On the domestic demand front, meanwhile, both consumption and investment growth decelerated. The slowing in the pace of consumption growth was due in part to a deterioration in the incomes situation in the October to December quarter, caused by the termination in August, 2017, of the increased benefits payments to low income earners. In addition, investment growth was affected by a pause in aggressive private sector investment caused by the export growth spurt.

Looking ahead to the future, it is expected that export growth will continue to lose momentum due to the continuing recoil in response to the 2017 growth spurt and the lull in IT demand growth. On the other hand, growth in domestic demand is expected to pick up, due to factors such as vigorous election related consumption around the lower house elections that take place in the spring. Given the foregoing, it is expected that further deceleration will be able to be avoided once 2018 gets underway.

## ■ External factors caused ringgit appreciation in 2017

The ringgit's exchange rate against the dollar in 2017 switched from a weak ringgit to a strong ringgit. Among the causes of the ringgit's appreciation were the fact that US and European monetary policy normalization movements and interest rate hikes remained moderate, and that Malaysia's economy picked up as a result of increased export growth following the global economic recovery and expanded IT demand. The strong ringgit has many benefits for the Malaysian economy, such as having the effect of curbing import inflation and corporate foreign currency denominated debt. However, the ringgit's appreciation is not due to growing market confidence in the Malaysian economy as a result of the resolving of issues through economic structural reform, such as the fiscal deficit and resource export dependence, and attention must still be paid to the uncertainty of ringgit sustainability.

Looking ahead to the future, it is highly unlikely that the ringgit will depreciate suddenly in the foreseeable future, given that monetary tightening activity in the West is expected to be moderate. However, former Prime Minister Mahathir has announced that he will run in the spring general elections as the opposition party candidate, and the ruling party is expected to face a tough election fight, leading some to warn of the risk that investors pessimistic about the instability of Malaysian politics will withdraw their capital from Malaysia. For the time being, the focus will be on whether the general election can go ahead smoothly, and whether the post-election government will be able to settle down to the task of implementing economic structural reform.

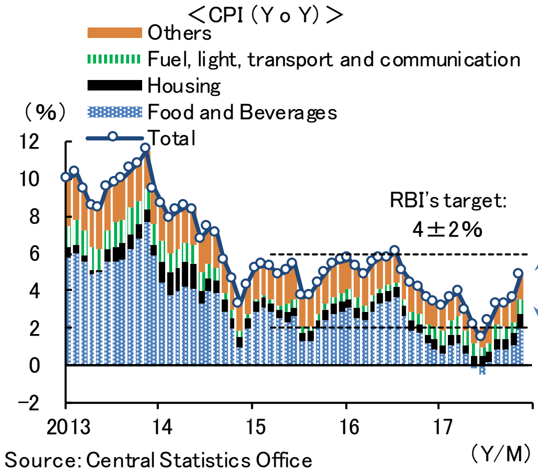
**(Yuta Tsukada)**

# *India* *Economy continues to pick up*

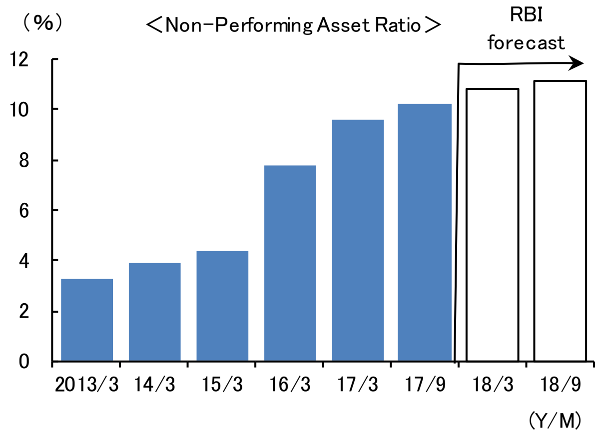
## ■ Manufacturers' PMI reaches highest level in five years

The Indian economy has continued to improve since the latter half of 2017, after a calming of the turmoil that followed the demonetization of high value notes in November of 2016, and the introduction of a GST (Goods and Services Tax) in July of 2017. In the PMI (purchasing managers' index) for December of 2017, the composite index improved to a new high for the first time in one year and two months, with the manufacturing industry recording its highest level in five years.

Meanwhile, in terms of monetary policy, from the perspective of making preparations against increased inflationary pressure following the economic improvement, and against the risk of capital outfow in the wake of monetary policy normalization in Europe and the US, India's policy stance has shifted from "easy" to "neutral". With the consumer price index for November of 2017 at 4.9%, compared to the same period in the previous year, the highest growth rate since August of 2016, India's central bank decided at its monetary policy meeting in early December, 2017, to keep the policy interest rate (repo rate) unchanged at 6.0% for the second meeting in a row.



Source: Central Statistics Office



Source: Reserve Bank of India

## ■ NPA issues persist

Although the banks' non-performing asset ratios are climbing at a slower pace, due to the economy having begun to improve, the risk of an economic downswing caused by non-performing asset issues continues to smolder. According to central bank's Financial Stability Report for December of 2017, the non-performing asset ratio as of September of 2017 was 10.2%, 0.6% points up from March of that year. The bad loan ratio including restructured loans has topped 12%. In terms of specific industries, non-performing loan ratios are rising and staying high in mining and metal goods manufacturing, which are affected by the stagnation in the prices of raw materials, and infrastructure related industries, where projects continue to be stalled due to delays in land acquisition, etc. In order to speed up the disposal of non-performing assets, the government has been pushing through a range of measures, such as the reform of the state owned banks, the improvement of the bankruptcy laws, the introduction of a debt to equity conversion plan, and the relaxation of foreign capital involvement in asset reconstruction companies, but even with these initiatives, non-performing asset ratios are widely expected to continue to trend mildly upwards.

In addition, the strict new capital adequacy standard "Basel III" is due to be applied from March of 2019, which is expected to cause financial institutions' lending capacity to decline, with the concern being that this will be a factor curbing investments from the fund supply side. In order to avoid these risks, in October of 2017 the government announced plans to implement capital reinforcement policies over the period 2018 to 2019, worth a total of 2.1 trillion rupees, more than the cumulative total of capital injections into the banks over the past ten years. In addition, central bank has also instructed the commercial banks to commence bankruptcy proceedings as soon as possible for tens of companies that account for about 40% of non-performing assets. If these initiatives can proceed smoothly, then it is thought likely that the economic downside risk from the financial side will gradually shrink.

**(Shotaro Kumagai)**

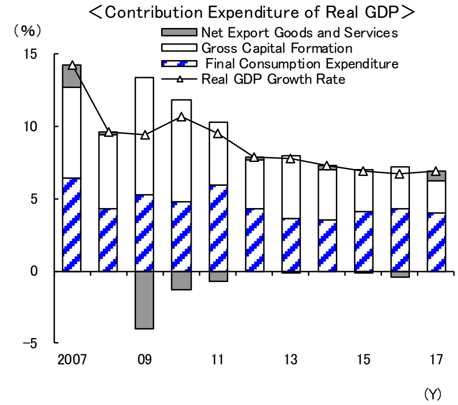
# China 2017 economic growth rate 6.9%

## ■ 2017 a year of economic recovery

China's real GDP growth rate in the October to December quarter of 2017 was 6.8%, compared to the same period in the previous year, the same level as the July to September quarter. As a result, the growth rate for the whole year 2017 was 6.9%, coming in above the government's target (approx. 6.5%). In spite of the fact that retail sales and fixed asset investment have been showing signs of losing impetus recently, on an annual basis, 2017 was a year of economic recovery.

The main reason that the growth rate exceeded the previous year's level for the first time in seven years was the growth in foreign demand. In response to the global economic recovery, trade found itself on the path to recovery, and both imports and exports exceeded the previous year's figures for the first time in three years. As a result, the contribution of net export growth for 2017 changed to positive (0.6% points) for the first time in three years, providing a boost to the growth rate.

<Contribution Expenditure of Real GDP>




Source: National Bureau of Statistics, CEIC

In terms of domestic demand, personal consumption continued to perform strongly, against the backdrop of improved employment and incomes environments. Nominal retail sales in 2017 grew strongly at 10.2% compared to the the previous year. In Singles Day sales on November 11, online retail giant Alibaba alone netted 168.3 billion yuan (just under three trillion yen) in one day, and the scale of the sales and pace of expansion have become major topics of discussion. In this way, Internet sales are continuing to grow strongly and are boosting consumption growth overall.

In terms of investments, those aimed at infrastructure posted growth in excess of the previous year's performance, but other categories were generally sluggish, so that fixed assets investment (excluding rural households) for the whole year 2017 struggled to grow 7.2%, year on year. In addition to the government's shifting of its policy priority to one of investment restraint, against the backdrop of economic recovery and overheating in the housing market, the slow investment growth appears to have been due to the fact that businesses have begun to favor debt repayment as a means of controlling excess debt, and are holding back from plant and equipment investment.

## ■ Economic slowdown expected to be slight

In looking ahead to how the economy will fare in the future, the focus will be to what extent the Xi Jinping administration can manage the economy by strengthening monetary tightening.

At the Central Economic Work Conference, held in December of 2017, 1) the prevention of financial and other major risks, 2) poverty alleviation, and 3) the prevention of environmental pollution, were presented as priority issues to be tackled by 2020. It was unusual to make the decision to hammer out a three year policy at this Conference, where usually the economic management policy for the following year is confirmed. The policy for 2018 includes tighter control of local government debt under fiscal policy, and money supply control under monetary policy. From these points, it may be judged that this year will be one that will see a strengthening of the tighter monetary stance. Nevertheless, the basic policies such as the "make progress while ensuring stability" line, "proactive fiscal policy" and "prudeant monetary policy", have been firmly maintained. Measures aimed at stimulating consumption were also continued, such as the exemption of a vehicle acquisition tax on three types of eco-cars. In this way, since the Xi Jinping administration seems likely to be able to maintain macro-economic control that takes economic performance into consideration, the expectation is that the scale of economic slowdown will be slight.

<Main Points of The Central Economic Work Conference>

| Decisions | Main Points |
|---|---|
| Priority Issues to be Tackled by 2020 | 1) the prevention of financial and other major risks, 2) poverty alleviation, and 3) the prevention of environmental pollution |
| Basic Economic Management in 2018 | Making progress while ensuring stability |
| Fiscal Policy | Maintaining proactive fiscal policy, and strengthening local government's debt management |
| Monetary Policy | Under the prudent monetary policy, appropriating money supply management, avoiding system risk |

Source: Chinese Communist Party's Official Site

**(Junya Sano)**