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Topics *China moves towards prevention of instability in the financial system*

In China, a bank has been taken over by the government for the first time in 20 years. The risk of bank failures has been increasing as a hasty deleveraging policy caused more damage than anticipated to regional economies.

■ China's financial regulatory authority seize control of Baoshang Bank

On May 24, China's financial regulatory authority took control of a bank for the first time in 20 years. The People's Bank of China and the China Banking and Insurance Regulatory Commission (CBIRC) announced they would take over the control of Inner Mongolia-based Baoshang Bank starting from May 24, 2019 until May 23, 2020. The management of Baoshang Bank will be entrusted to the China Construction Bank (CCB), one of the big five banks in China. Baoshang Bank is a private bank with a large amount of loans to private companies and individuals. With total assets of 431.6 billion yuan and an outstanding balance of loans amounting to 156.5 billion yuan as of the end of 2016, Baoshang Bank is categorized as a medium-sized bank. In the Chinese classification, Baoshang Bank falls under the category of joint-stock commercial banks. While its total assets are rather small in this category, their amount exceeds the average total assets of all banks in China.

＜Overview of Banking and Financial Institutions in China＞

Category		Total Assets (100 Million Yuan)	Number of Corporate (Entities)	Total Assets per Entity (100 Million Yuan)
Commercial Banks		1,815,058	1,304	1,392
	Large-scale Commercial Banks	865,982	5	173,196
	Joint-stock Commercial Banks	434,732	12	36,228
	City Commercial Banks	282,378	134	2,107
	Rural Commercial Banks	202,680	1,114	182
	Foreign Banks	29,286	39	751
Other Financial Institutions		507,474	3,094	164
	Policy Banks	229,935	3	76,645
	New-type Rural Financial Institutions and Postal Savings Banks	95,072	n/a	n/a
	Private Banks	n/a	8	n/a
	Rural Cooperative Banks	4,359	40	109
	Rural Credit Cooperatives	79,496	1,125	71
	Others	n/a	n/a	n/a
Total of Banking and Financial Institutions		2,322,532	4,398	528

Source: The Japan Research Institute, Ltd. based on the Annual Report 2016 of the China Banking Regulatory Commission

The main purposes of the aforementioned takeover are the protection of depositors and creditors as well as the prevention of instability in the financial system.

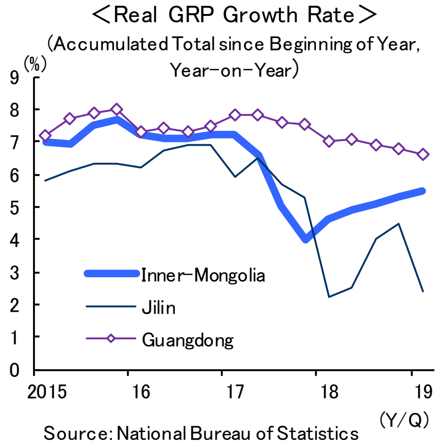
The People's Bank of China jointly with the CBIRC and the Deposit Insurance Fund will guarantee the entire amount of principal and interest of retail deposits of Baoshang Bank while continuing normal business operations including acceptance of deposits and allowing withdrawals. Meanwhile, the any principal and interest of from the Bank's financial instruments for retail customers will also be fully guaranteed. As for deposits of corporate customers and other claims, the principal and interest will be fully guaranteed up to 50 million yuan and at least 80% of principal and interest will be guaranteed for amounts exceeding 50 million yuan based on the consultation between the financial regulatory authority and the creditors.

Seizure of banks had not taken place for a long time in China. This was the first takeover of a bank in 21 years since the seizure of Hainan Development Bank in 1998. At that time, the financial regulatory was forced to take such measures as the injection of public funds and the disposal of non-performing loans as a result of the bank's deepening non-performing loan problem. Since Hainan Development Bank had a large amount of non-performing loans, the regulator ordered suspension of business operations and liquidation of the bank. Even in China, there have not been many cases of seizure in which management rights are forcibly seized by the state power.

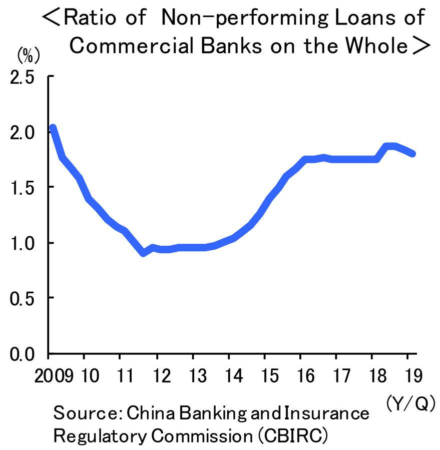
■ Hasty deleveraging policy caused significant damage to banking operations

The worsening of Baoshang Bank's business operations became apparent around 2017. The bank's credit rating was lowered due to an increase in the ratio of non-performing loans.

The main reason behind this seems to be economic slowdown in Inner Mongolia, which was triggered by the hasty deleveraging policy. In Inner Mongolia, strict investment controls and shadow banking regulations have been implemented, and a number of infrastructure projects including those for subways, airports, highways have been suspended since August 2017. As a result, fixed asset investment in the Inner Mongolia, which had maintained two-digit growth in the past, continued to decline in 2017 and 2018. The real GRP growth rate rapidly decreased from 7.2 % year-on-year in 2016 to 4.0% year-on-year in 2017. The growth rate did not recover much in 2018 with 5.3% year-on-year. It is apparent that the deterioration in profitability of lending weighed heavily on the operations of Baoshang Bank.



In fact, 70% of Baoshang Bank's outstanding balance of loans was for Inner Mongolia, and the bank had been providing financial assistance to a wide range of industries including wholesale, manufacturing, mining and real estate industries. Baoshang Bank's published non-performing loan ratio was 1.7%, which was virtually a similar in level as to the non-performing loan ratio of the commercial banks as a whole. However, this non-performing loan ratio does not seem to have reflected reality as there are a certain number of cases in which loan assets that should be recognized as non-performing loans are deemed to be sound receivables in China.



Moreover, another factor behind the worsening business conditions was the fact that Baoshang Bank had to rely on the interbank market and other more costly means for its loan funds as it did not have sufficient capability to acquire deposits from retail and corporate customers. Of its total liabilities of 401.8 billion yuan at the end of 2016, deposits were 193.6 billion yuan and funds raised through the interbank market were 71.6 billion yuan. Such funds raised through the interbank market apparently reached 50% at the end of September 2018.

Actually, Inner Mongolia is not the only place suffering from economic slowdown due to the impact of the hasty deleveraging policy. For example, Tianjin's real growth rate has sharply declined during the past three years from 9.1% to 3.6% and then 3.6%. The situation has also been severe in Jilin whose real growth rate dropped from 6.9% to 5.3% and then 4.5%. On the other hand, in regions like Guangdong, Jiangsu and Zhejiang which depend highly on exports, although the economy has been slowing down due to the impact of the U.S.-China trade frictions, the damage caused by the deleveraging policy has been minimal and the economic slowdown has been modest as their dependency on infrastructure investment is low.

It seems that banks that operate in regions such as Tianjin and Jilin have also faced deterioration in revenues from borrowers. In fact, there are a substantial number of small and medium-sized banks that have to raise funds through the interbank market and by other means since they are also failing to acquire deposits as in the case of Baoshang Bank.

On June 2, in addition to explaining the background behind the decision to take over Baoshang Bank the regulator announced that it will lower the cash reserve ratio for small and medium-sized banks throughout China on June 17. As a result, it is anticipated that funds of approximately 100 billion yuan will be provided to the financial system to contribute to the stabilization of liquidity of small and medium-sized banks. Moreover, China's regional governments plan to inject public funds into banks that fear bankruptcy. Since there are a significant downside risks for the Chinese economy as a result of uncertainty in the financial system if the government does not move quickly, continued attention must be paid to movements in China's financial sector.

(Shinichi Seki)

Topics *Taiwan's manufacturing sector is shifting away from China*

Owning to the worsening of China's business environment, Taiwan's manufacturing industry is moving back its production base from China to Taiwan. However, this move to return to Taiwan is temporary, and it is anticipated that in the future the production base will be eventually be shifted to Southeast Asia which has cheaper labor costs.

■ What is behind the return to Taiwan?

While Taiwan's manufacturing sector had until the mid-2010s, actively accelerated its shift of production to China, there has been a move in recent years to return its production base back to Taiwan. Looking at Taiwan's manufacturing industry's production bases for overseas demand and its share by region, while the ratio of China had continued to steadily increase until around 2015 and 2016, the ratio for Taiwan remained on a declining trend. However, this has reversed in recent years.

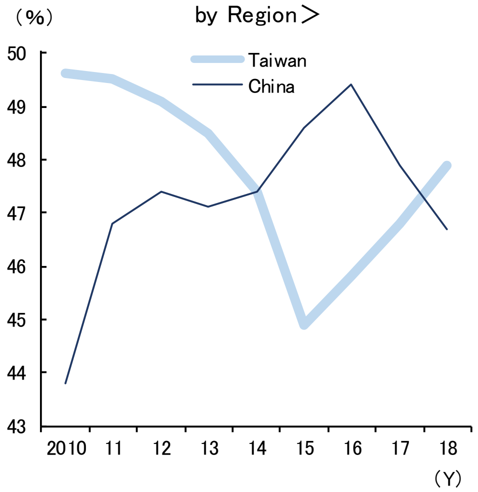
This situation can be attributed to China's worsening business environment.

Firstly, a significant turning point was the tightening of environmental regulations. Amid the deepening of environmental problems such as air pollution due to PM2.5, the Chinese government amended the Environmental Protection Law in 2014 for the first time in 25 years, and thus stipulated severe penalties against offending companies as well as laying responsibilities on administrative supervision. This resulted in strict regulatory enforcement, which included fines, production suspension orders and the seizure of equipment, thus corporate production activities became restricted.

Next was a rise in labor costs. In 2010 the level of China's labor costs, even in coastal areas, was less than 30% those of Taiwan. Following increases in the minimum wage, however, China's labor costs have now risen to approximately 60% those of Taiwan.

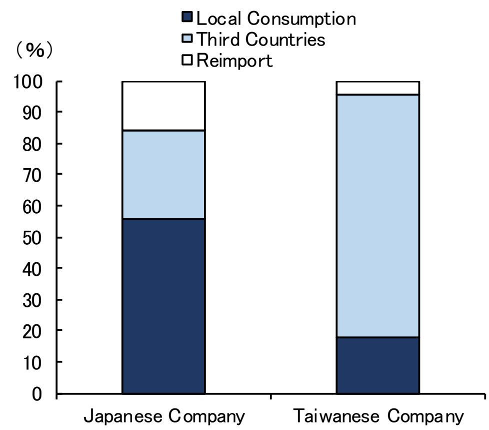
Furthermore, Taiwan's unique position with regard to its production base in China has also served as a factor prompting the shift of production back to Taiwan. Although China's deteriorating production environment is an ill wind for all foreign manufacturers, as far as Japan's manufacturing industry is concerned the shift of production base from China back to Japan has not been witnessed.

＜Production Ratio of Export Orders by Region＞



Source:Ministry of Economic Affairs

＜Sales Destination Ratio of Overseas Production Bases(2017)＞



Source:Ministry of Economy, Trade and Industry
Ministry of Economic Affairs
Note:As for Japanese Company, the statistics is for Asian Production Bases.

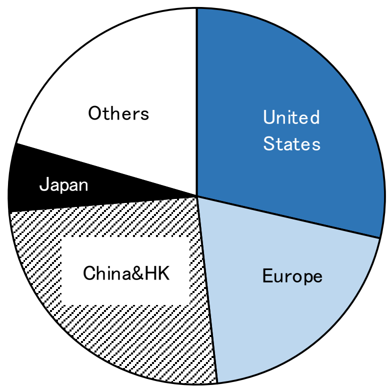
The differences between the two countries are rooted in the sales structure of the products manufactured in China. While the majority of products manufactured in China by Japanese companies are intended for the local consumption in China, nearly 80% of the products manufactured in China by Taiwanese companies are intended for the export to third countries. Since the production in China by Japanese companies has a strong aspect of "local production for local consumption," Japanese companies will not lightly decide to withdraw from China when the local production environment deteriorates. On the contrary, since Taiwanese companies have less such restrictions as Japan, they can select production bases relatively flexibly.

■ Impact of the U.S.-China trade frictions

Furthermore, the U.S.-China trade disputes have emerged as a new factor behind the shift from China.

Orders destined for the United States account for just under 30% of export orders received by Taiwanese companies. For this reason, the rise in tariffs on Chinese goods by the United States can be a significant burden on Taiwanese companies with a production base in China. Since smartphones and laptops, which are mainstay export items destined for the United States, are not currently included in the scope of the tariff rise, there has not been much of a move by Taiwanese companies to immediately scale down their production activities in China. However, in a prolonged conflict between the United States and China, the concentration of production sites in China could become a considerable risk as it is not clear what kind of sanctions the United States may impose on China in the future. Given this, it is anticipated that Taiwanese companies will decrease their relative dependency on China by increasing production capacity outside China in the future.

＜Ratio of Export Orders by Destination (2018)＞



Source:Ministry of Economic Affairs

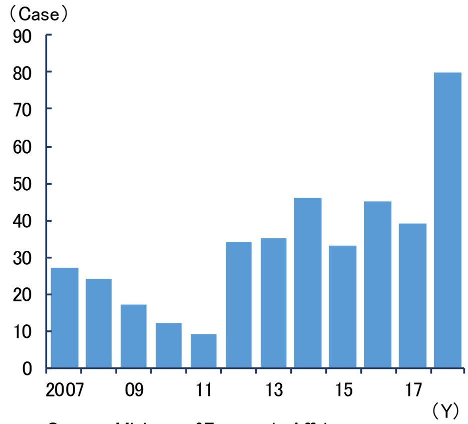
■ What can we expect in the future?

Despite the foregoing, there is a little possibility that the shift of production base back to Taiwan will continue to accelerate. While the gap in wages between Taiwan and China is narrowing, Taiwan's labor costs are as high as developed countries. Therefore, Taiwan's attraction as an export base is low to start with. The current movement seems to be the result of an increase in operating rates of production sites in Taiwan with excess capacity as a temporary recipient of the shift of production base from China.

As for the future outlook, going forward there will be a move toward the reinforcement of production capacity in regions other than China and Taiwan, particularly in Southeast Asia.

The first reason is cheaper labor costs. For example, wage levels in Vietnam and the Philippines remain less than half of those in China.

＜Approved Outward Investment to Asean 5 by Taiwanese Manufacturing＞



Source:Ministry of Economic Affairs

The second reason is the accumulation of IT-related production sites in East Asia. As the production of electronic equipment requires a large number of parts, the manufacturers can save costs and lead times in parts procurement and maintain competitive advantage by establishing their production bases closer to East Asia countries such as Japan, China, Taiwan and Korea, which produce the majority of such parts. No matter how much cheaper the labor costs are, there is little advantage in shifting production bases to remote places such as South Asia.

In fact, signs of a shift of production to Southeast Asia by Taiwanese companies have already become apparent in statistics.

The number of Taiwanese companies' investment projects about manufacturing sector in Southeast Asia has been rapidly increasing, with more than double year-on-year in 2018. This indicates that Taiwanese companies have been newly establishing and expanding their production sites in Southeast Asia at a rapid pace.

If Taiwan's manufacturing industry, which boasts significant global shares in electronic parts and devices, takes a full-fledged move to expand production activities in Southeast Asia, there will be significant structural changes such as a further expansion in IT-related global supply chains. Japanese companies will also be required to optimize production, exports and logistics in line with these changes in the future.

(Michinori Naruse)