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Topics Chinese government pivots to avoid financial crisis

In China, there is growing concern that the real-estate market adjustment could develop into a financial crisis. However, the authorities have shifted their policy focus to risk containment, and a financial crisis is expected to be avoided for the time being.

■ Background to concern about a possible financial crisis

In China, debt is at a dangerous level, with the ratio of nonfinancial corporate debt to GDP reaching a level as high as that of Japan's during its bubble period. An increasing number of companies are saddled with inefficient operations and equipment, and their ability to service their debt is a concern. In particular, real-estate developers' ability to service their debt has declined markedly, and housing prices continue to fall. As a result, there is growing concern that the real-estate market adjustment could develop into a financial crisis.

The expansion of lending and fixed asset investment over the last decade has hindered efficient resource allocation. With the rate of increase in outstanding bank loans continuing to outpace economic growth, the ratio of outstanding bank loans to GDP rose from 130% at the end of 2015 to 170% at the end of September 2022.

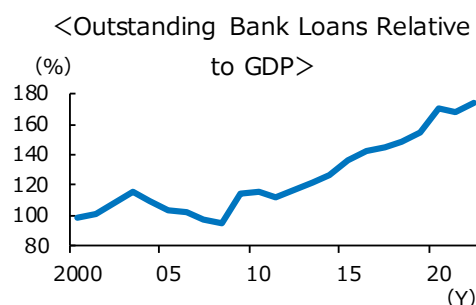
This implies that the amount of financing required to raise one unit of GDP is increasing and that financial efficiency is declining.

Although the recent expansion of loans has contributed to the development of strategic industries such as information and communications equipment, automobiles, and industrial robots, the increase in borrowing in these sectors, which contribute to the advancement of industry, has been relatively small. The increase in borrowing in the construction and real-estate sectors, which are engaged in urban development, has been much larger. The ratio of bank loans for real estate to GDP across all financial institutions rose from 30% at the end of 2015 to 44% at the end of September 2022. A breakdown shows that mortgages account for 76% of the total, while loans to real-estate development companies account for 24%.

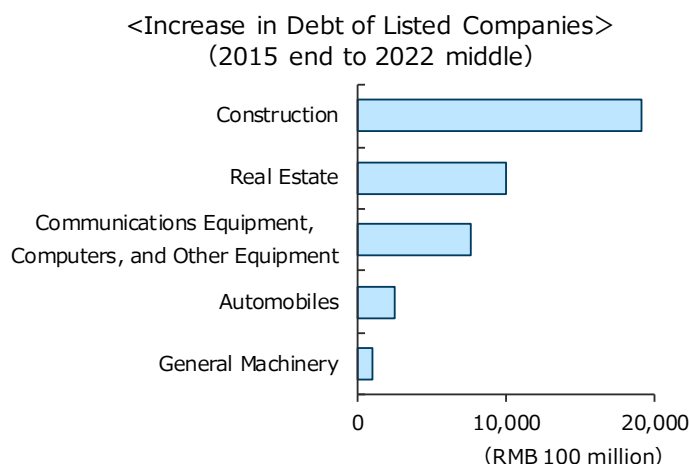
Against this backdrop, attention has focused on the sharp decline in sales in the real estate market and the impact of falling prices. Already, there have been cases of housing construction work being halted due to the financial difficulties of real-estate developers, resulting in problems such as properties not being delivered on the promised dates and buyers refusing to pay their mortgages. Some financial institutions are facing the risk of capital shortfalls as a result of non-performing real-estate loans and declining loan collateral values.

■ Authorities are focused on risk containment

However, the following three points suggest that a major financial crisis will be avoided: The first is that public funds are expected to be deployed quickly. In recent years, monitoring of financial institutions has been strengthened, and as a result, the authorities now have an accurate grasp of the magnitude of the risks



Source: Prepared based on People's Bank of China and National Bureau of Statistics of China
Note: The most recent figure is for September 30, 2022.



Source: Prepared by JRI based on data from Wind Database
Note: Aggregated financial data for all listed companies.

faced by each financial institution and the amount of public funds that would be needed to deal with any crisis. In addition, while in developed countries there are high political hurdles to injecting public funds into specific financial institutions because of the risk of public outcry, in China the hurdles are low because most people in the country expect authorities to intervene to stabilize financial markets.

In fact, when small and medium-sized financial institutions such as the Bank of Jinzhou have faced the risk of failure, state-owned banks and state-owned asset management companies have been quick to commit to taking equity stakes, preventing the spread of unrest in the financial markets. As the zero-COVID policy and real-estate market adjustments pounded financial institutions' balance sheets, the government provided full support to small and medium-sized financial institutions by injecting a total of RMB 210 billion to about 300 banks in 2020-21, with the cash coming from the issuance of special local government bonds. The Chinese government has shown no hesitation in injecting public funds, including an additional RMB 320 billion in 2022.

The second is that because of the government's strong control over financial institutions, mutual distrust among financial institutions and large-scale reductions in the provision of credit to firms are unlikely to occur. In recent years, financial institutions have taken an aggressive lending stance even as economic growth has slowed and corporate performance has been lackluster. This is because the authorities have adopted a policy approach of directly urging financial institutions to make loans. This approach involves tools such as so-called "window guidance" and its more sophisticated brother: MPA (Macprudential Assessment).

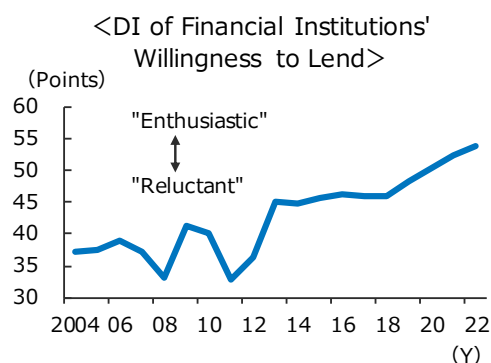
Since 2020, when the COVID pandemic began, the government has called on financial institutions to maintain their proactive lending stance and extend repayment deadlines to shore up corporate finances, even though problems have emerged in borrowers' ability to repay their debts. Principal and interest payments deferred by financial institutions in 2020 totaled RMB 7.3 trillion. MPA involves the periodic evaluation of financial institutions and the provision of guidance to them, and it has encouraged financial institutions to lend more aggressively by giving them higher scores for medium-term lending to small and medium-sized enterprises and manufacturers. Government control over finance is expected to increase further in the future, as the October 2022 Communist Party of China (CCP) Congress saw the CCP declare that guidance to financial institutions would be strengthened.

Although lending to real-estate development companies is currently sluggish, mainly due to government restrictions on such credit, lending is expected to gradually expand in the future. As evidence for this, in November 2022 the authorities announced in writing that they would be implementing full-scale financial support measures for the first time. The financial assistance measures comprise 16 items, including meeting reasonable financing needs of real-estate development enterprises, both state-owned and private, and allowing a one-year extension of the maturity date of loans that are due within six months of the date of the announcement of the notice, with no need to record the loans as nonperforming. Financial institutions are expected to abide by the government's request and re-expand their lending, thereby preventing a worsening of the cash crunch being experienced by real-estate development companies.

The third is that the economy is expected to recover due to increased fixed asset investment. The Xi Jinping administration has repeatedly followed a pattern of using state-owned enterprises and private companies with close ties to the government to prop up the economy by expanding investment in fixed assets whenever the economy slows, and as a result, potential bad loans held by financial institutions begin to decline and the risk of a financial crisis becomes more remote. In 2023, growth is expected to pick up as government-led investment expands and the economy benefits from the easing of activity restrictions following the scrapping of the zero-COVID policy.

However, such policy responses merely postpone the problem. As China's economy moves into a low-growth phase over the medium term, risk containment measures will become more difficult over time.

(Shinichi Seki)



Source: People's Bank of China

Note: The willingness-to-lend DI is calculated as "enthusiastic" minus "reluctant" plus 50. The survey covers approx. 5,000 industrial companies nationwide. These are average figures, with the most recent being for the January-March quarter of 2022.

Topics Concerns over the sustainability of Hong Kong's dollar peg

The Hong Kong Monetary Authority (HKMA) has implemented extensive currency intervention to maintain the dollar peg. Concerns over the sustainability of its dollar peg are expected to continue as uncertainty about its status as an international financial center increases.

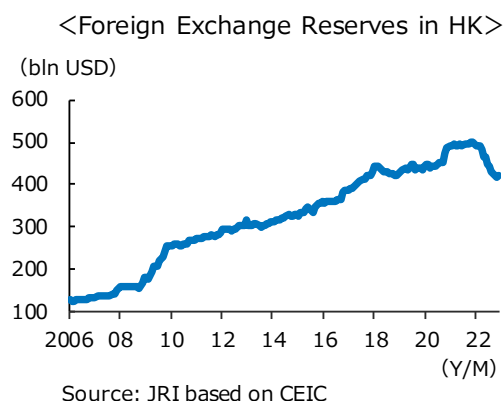
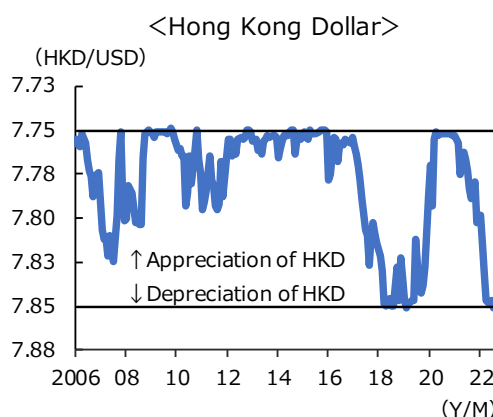
■ HKD is under downward pressure amid fears of failure to defend the currency

Entering 2022, the currencies of many countries/territories depreciated against the U.S. dollar due to rapid monetary tightening in the United States. The Hong Kong dollar, which is pegged to the U.S. dollar under a currency board system, is also coming under increasing downward pressure. As the Hong Kong dollar reached the weak end of its permitted trading range (HK\$7.75-7.85 to US\$1), the HKMA defended the currency through foreign exchange intervention from May to November, buying up HK\$242.1 billion. While such actions in the Hong Kong dollar market occur frequently, the total amount of intervention during the downswing in 2018 was HK\$125.6 billion, so the scale of the current round is almost double. As a result, foreign exchange reserves, which fund the interventions, had rapidly declined by 14.8% ytd in November. The amount of intervention was also inflated by some market participants who increased their short positions (selling volume) as they saw an increased likelihood that the HKMA would not be able to defend the currency.

Since the 2000s, Hong Kong has been more economically linked to mainland China than to the U.S., and many argue that an RMB peg or a currency basket that includes the RMB would be more appropriate than a dollar peg. Another problem with the dollar peg is the need to tie monetary policy with that of the U.S., which has a different economic cycle. This means that interest rates in Hong Kong have been hiked significantly despite the economic downturn in the territory.

Despite the various problems with Hong Kong's dollar peg system, Chief Executive of HKMA, Eddie Yue stressed in a press release in July that the dollar peg is and will remain essential to Hong Kong's monetary and financial stability. The Chinese authorities also appear to support this stance, with the CCP-affiliated Securities Times newspaper arguing in an August 3 article that the dollar peg is an important foundation for Hong Kong's currency and financial stability. Specifically, the paper pointed out that given the current situation where most trade and investment transactions are denominated in US dollars, a dollar peg is beneficial in terms of foreign exchange risk management and is important for increasing trade and attracting investors to Hong Kong. With the slow opening of mainland China's financial markets to the outside world, little progress has been made in the internationalization of the RMB and the development of international financial functions in major cities such as Shanghai and Shenzhen, so the financial functions of Hong Kong and the dollar peg that underpins them remain of great importance to China.

After around seven months of currency intervention by the HKMA, the Hong Kong dollar began to rise against the U.S. dollar, and has now recovered to the middle of the permitted trading band. This was due to 1) the HKMA's strong willingness to defend the dollar peg, 2) the narrowing of the market interest rate differential between the U.S. and Hong Kong, and 3) increased capital inflows following the relaxation of China's zero-COVID policy and the removal of border entry restrictions in Hong Kong.



■ There are concerns about Hong Kong's position as an international financial center

However, market concerns relating to Hong Kong's maintenance of the dollar peg have not been completely resolved. Even if the Chinese and Hong Kong authorities strongly desire to continue the dollar peg, if Hong Kong cannot maintain its status as an international financial center, it will not be able to attract global money, making it difficult to maintain the peg system.

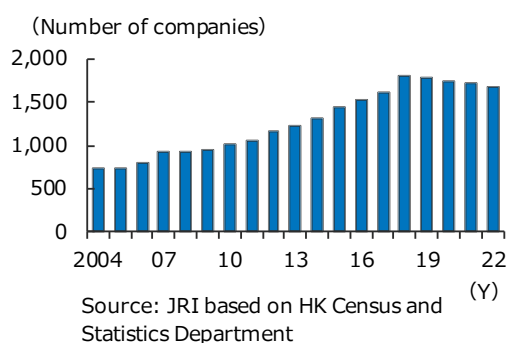
In particular, there have been concerns about the adverse effects on the free and international Hong Kong market since the national security law came into force in 2020. In fact, the number of foreign financial institutions with offices in Hong Kong has been decreasing every year, dropping to 1,683 in 2022, down 123 from the peak year of 2018. In addition, Hong Kong's population as of June 2022 had fallen by 120,000 year-on-year (or by 100,000 if the effect of births and deaths is excluded), and the outflow of labor is also becoming more serious.

The growing presence of Singapore, a rival financial center in Asia, has also contributed to the decline in the international standing of the Hong Kong market. The tax rates in Hong Kong and Singapore are considerably lower than those in others, which is a major attraction for investors. Both income tax rates (maximum rate: 15% in Hong Kong and 22% in Singapore) and corporate tax rates (16.5% and 17%, respectively) are lower in Hong Kong than in Singapore. Hong Kong also has an advantage over Singapore as an international financial center in terms of easy access to the financial markets of China, the largest economy in Asia. However, there is growing concern that the Chinese government will tighten its control over Hong Kong and that many wealthy individuals and investors are fleeing Hong Kong for Singapore, as Singapore has succeeded in shifting to a with-COVID approach more quickly than Hong Kong. In the latest ranking of international financial centers released in September 2022 by the British think tank Z/Yen Group, Hong Kong dropped to fourth place from third place in March, while Singapore rose from sixth to third place, making it the highest-ranked city in Asia. According to a triennial survey by the Bank for International Settlements (BIS), Hong Kong's share of foreign exchange turnover in 2022 was 7.1%, down from 7.6% in 2019, while Singapore's share was 9.4%, up from 7.7% in the previous survey.

In Hong Kong, although the negative impact of the COVID-induced activity restrictions on the economy is expected to decline in the future, there is still a suspicion that its financial market will not remain free if the Chinese government's control increases. As a result, the withdrawal of financial institutions and the outflow of personnel may continue. If this happens, Hong Kong's dominance as an international financial center could continue to decline. Under such circumstances, renewed pressure for currency depreciation and capital outflows in the market would inevitably reignite fears that Hong Kong's dollar peg will be unsustainable.

(Minoru Nogimori)

<Foreign-affiliated Companies in HK>
(Financing and Banking)



<FX Trading Shares in Global Turnover>

