GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

China Monitor

MONDAY, JULY 18, 2022

CHINA MONITOR

The Monitor aims to provide a regular update on the policy setting, credit conditions and market trends in China. It also includes analytical features which offer more in-depth analyses of selected macrofinancial issues related to China.

KEY HIGHLIGHTS

Market trends. ***Market sentiment deteriorated sharply amid the COVID-19 outbreaks during March-May,*** resulting in falling equity prices, RMB depreciation, increased market uncertainty, and foreign fund outflows. As the outbreaks were brought under control, ***Chinese assets recovered strongly,*** underpinned by a re-opening optimism and a prospective conclusion of regulatory tightening in the tech sector. However, market sentiment weakened somewhat in recent weeks due to renewed concerns about rising local COVID infection. ***Liquidity remains ample,*** with the key interbank repo rate (DR007) largely staying below the policy rate. ***Long-end government bond yields have been little changed,*** a sharp contrast to the global trend of rising yields in response to high inflation. Inflationary pressure remains limited in China due to weakening growth momentum. Analysts expect that China will likely miss its growth target this year.

Policy setting. ***There has been no adjustment in monetary policy since late April.*** The fiscal policy, mainly in the form of infrastructure investment and tax rebates, is in the driving seat to support economic activity. Meanwhile, monetary policy is playing a supplementary role by ensuring ample liquidity and adequate credit provision. The People's Bank of China (PBC) has increasingly relied on structural policy tools such as re-lending schemes to direct credit to the targeted sectors (e.g., small businesses, carbon mitigation, and innovation). Banks are instructed to grant repayment deferrals to certain borrowers affected by the recent COVID-19 outbreaks; reportedly, major banks are taking a cautious approach to potential problem loans. Going forward, China faces a stark policy tradeoff between maintaining the zero COVID policy, supporting economic activity, and limiting financial vulnerabilities. ***Measures to support the financing of infrastructure investment have been rolled out in recent weeks.*** Authorities approved an additional lending quota of policy banks and raised funds for equity investment in infrastructure projects. Reportedly, authorities considered issuing more special local government bonds.

Credit conditions. ***Growth of total credit excluding government bond credit has moderated slightly this year.*** Through May, growth of total social financing has picked up on the back of front-loaded government bond issuance and growing bill financing. Growth of longer-term bank lending remains relatively weak although there were some signs of recovering credit demand in June.

Property sector. ***Financial stress has deepened as a sharp decline in home sales*** amid lockdowns exacerbated property developers' liquidity strains. Markets have priced in debt restructuring of many property developers. Housing markets do not show any sign of a strong recovery, while mortgage lending remains weak despite various city-level policy measures to boost home-buying demand such as relaxing home purchase restrictions and lowering down-payment requirements. Efforts to proactively handle distressed property developers seem limited. More recently, some homebuyers called for suspending their mortgage payments (of unfinished, pre-sold homes) as property developers stop construction and/or fail to deliver housing on time.

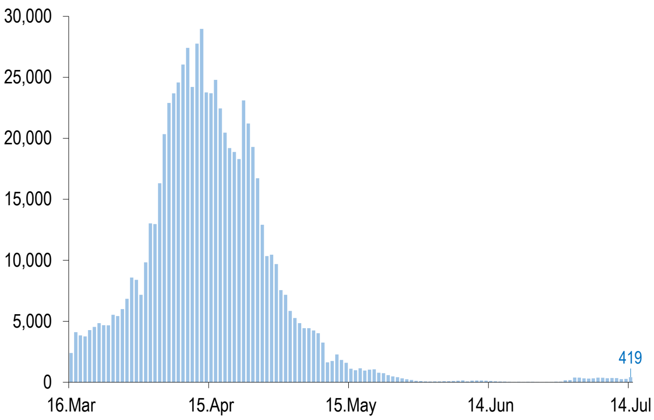
This Monitor was prepared by Phakawa Jeasakul and Hong Xiao (IMF Resident Representative Office in Hong Kong SAR).

Analytical features. ***This monitor provides an overview of China's securitization of real estate financing.*** Securitization has grown rapidly in China, even though the regulatory frameworks are not established by laws and have not been tested in courts. Banks can securitize their mortgage loans, but mortgage-backed securities (MBS) play a limited role in financing their mortgage lending and/or offloading credit risk. Meanwhile, real estate firms can rely on enterprise asset-backed securities (ABS) and asset-backed notes (ABN) to bolster their financing options. One important vulnerability is that a notable portion of ABS have unfinished housing as their underlying assets; originating banks may be exposed as MBS typically have a clause that requires them to buy back mortgage loans in a case that the final mortgage registration is not completed (e.g., if housing is not delivered).

China's asset prices were under significant downward pressure during COVID-19 outbreaks in March-May, but market sentiment has improved in recent weeks

The lockdowns, especially in Shanghai, significantly affected market sentiment in April and May.

1. COVID-19 Infection: New Local Cases, 2022

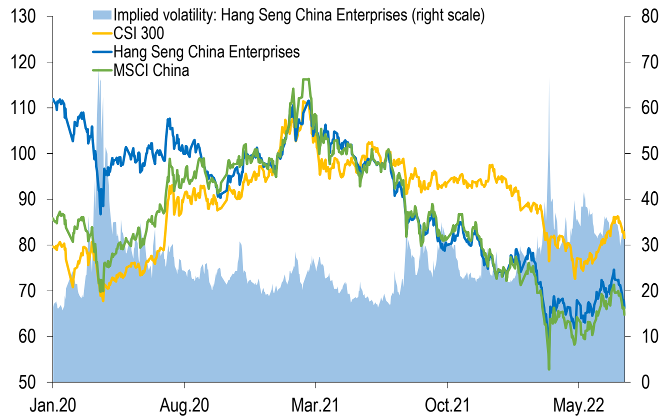


Sources: CEIC; and IMF staff calculations.

- China remains firm with a zero COVID policy. The April Politburo meeting reiterated the zero COVID policy and maintained the economic growth target.
- The lockdowns in Shanghai and other cities to contain COVID outbreaks resulted in significant supply-chain disruptions.
- China appears to shift to rely more on regular mass testing to help detect and contain outbreaks so that large-scale lockdowns could be avoided.

As markets were concerned about the economic impact of COVID-19 outbreaks, equity prices declined.

2. Equities: Prices and Implied Volatility
(End-2020 = 100; Based on prices in RMB)

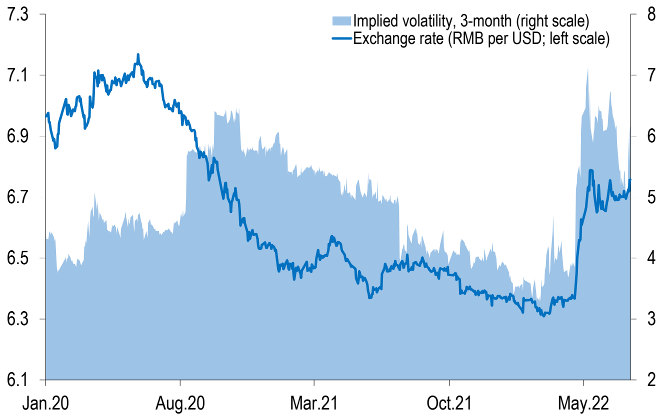


Sources: Bloomberg; and IMF staff calculations.

- Chinese equities after plummeting to a trough in late April have recovered (CSI 300: +19%; HKSAR-listed: +17%) on optimism around the re-opening together with forthcoming policy support to achieve the growth target.
- The rally has also been supported by optimism around an end of regulatory tightening in the tech sector.
- After spiking in March, implied volatility has fallen, though remaining relatively high.

Meanwhile, RMB depreciated, along with rising market volatility, on the back of foreign fund outflows.

3. RMB: Exchange Rate and Implied Volatility

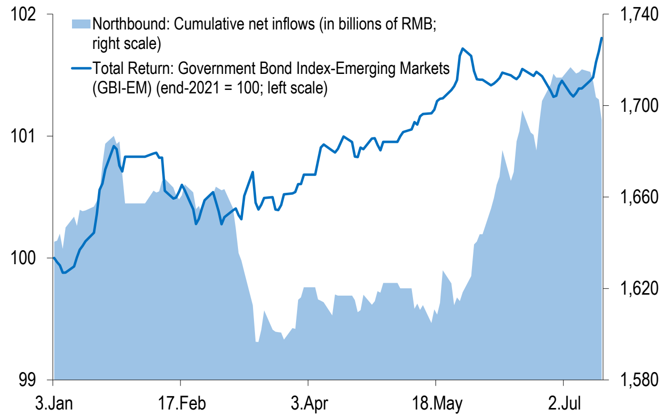


Sources: Bloomberg; and IMF staff calculations.

- Bond and equity outflows, as well as the weakening economic momentum, create depreciation pressure on RMB. Meanwhile, the PBC has consistently set RMB fixing stronger-than-expected since late April.
- While RMB started stabilizing more recently, implied volatility remains elevated.

However, foreign funds quickly returned to China's stock market after the COVID-19 situation turned the corner.

4. Government Bond Total Return, and Northbound Cumulative Net Inflows, 2022



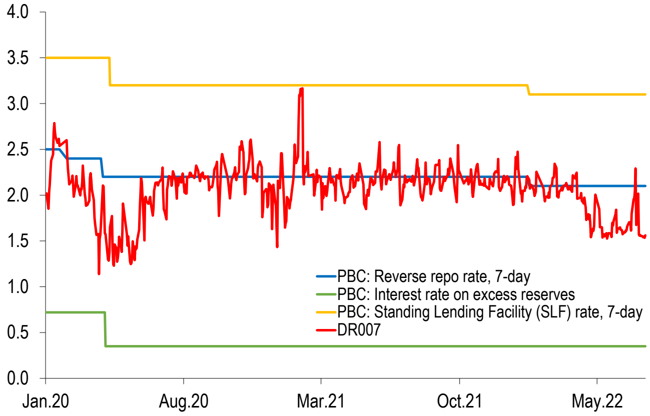
Sources: Bloomberg; and IMF staff calculations.

- Foreign funds have returned to China's stock market, supporting the recovery of equity prices.
- Bond outflows continue on the back of widening interest rate differentials. Nevertheless, sales by foreign investors have had only a limited impact on bond prices.

Monetary policy easing has been relatively limited, but liquidity remains ample partly thanks to weakening credit demand

With ample liquidity, the key interbank repo rate has fallen below the policy rate despite no changes in policy rates and reserve requirement ratios (RRRs) since late April.

5. Short-term Policy and Market Rates
(In percent)

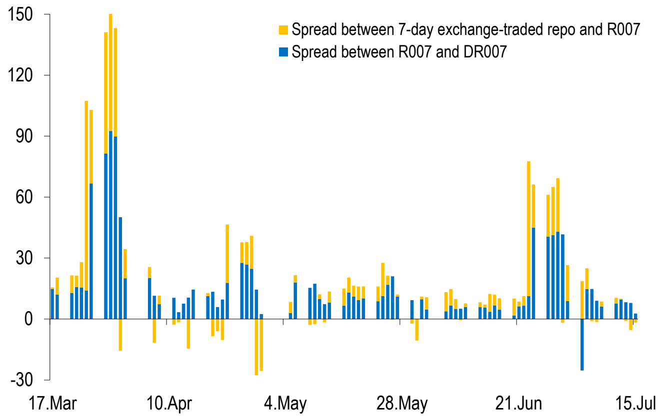


Sources: CEIC; and IMF staff calculations.

- The PBC has kept the monetary policy setting unchanged since the last RRR cut in late April; policy rates have remained unchanged since mid-January.
- Until the last week of June, the PBC had not injected liquidity via open market operations (OMOs) and the medium-term lending facility (MLF) since April, but overall liquidity appears ample and stable.

Spreads of repo rates widened, along with rising DR007, toward the end of June due to strong quarter-end liquidity demand. The spreads have narrowed in July.

7. Spreads of 7-day Repo Rates, 2022
(In basis points)

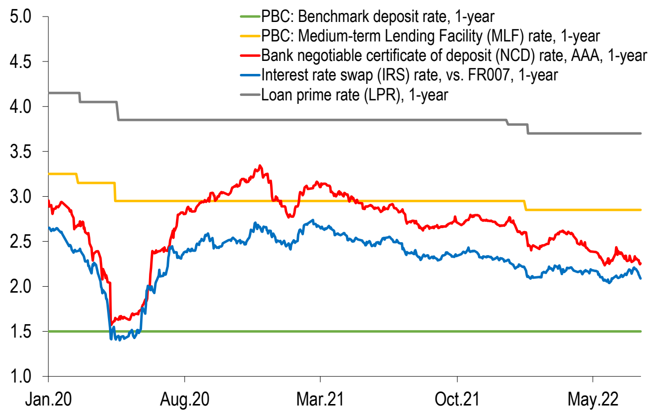


Sources: Bloomberg; and IMF staff calculations.

- Spreads of repo rates remained limited except for during the last week of June. Liquidity conditions seemed more ample around end-June than around end-March.
- In response, the PBC has injected more liquidity to keep overall liquidity ample in line with the previously announced policy statement.

Meanwhile, the 5-year loan prime rate (LPR) was lowered by 15 bps to 4.45 percent in late May; the 1-year LPR was kept unchanged.

6. Medium-term Policy and Market Rates
(In percent)

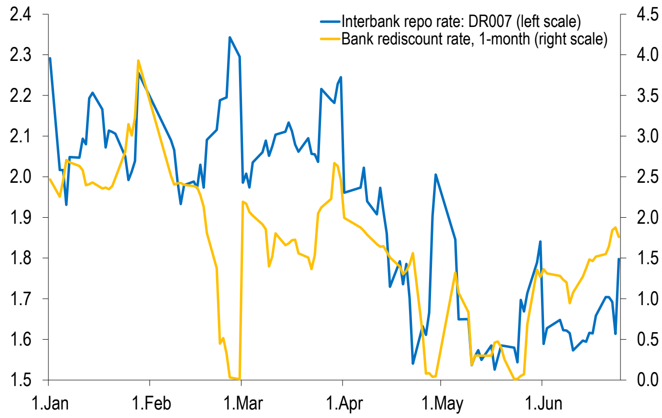


Sources: Bloomberg; and IMF staff calculations.

- In May, the PBC modified the deposit rate self-discipline mechanism, which is used to control bank deposit rates. Previously, banks could set deposit rates higher than the benchmark deposit rate up to certain spreads. Following the change, banks are encouraged to adjust deposit rates according to the 10-year central government bond (CGB) yield and the 1-year LPR.

Bank discount rates tend to fall to near-zero toward end-month this year as banks aggressively boosted their bill financing to meet credit growth targets.

8. Repo Rate and Bank Rediscount Rate, 2022
(In percent)



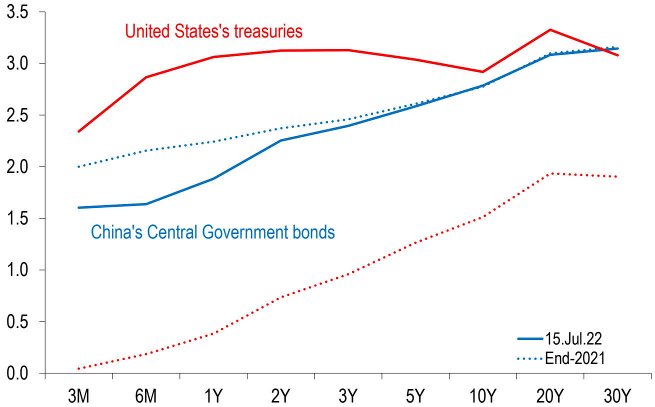
Sources: Bloomberg; WIND; and IMF staff estimates.

- Toward the end of a month, repo rates tend to rise due to strong month-end liquidity demand. At the same time, banks boosted bill financing, which is counted as part of their lending, in order to meet authorities' window guidance amid weak credit demand.
- Such a development highlights an uneven distribution of liquidity within the system.

Bond outflows continued, while a stock rally benefited from a re-opening optimism and a prospective conclusion of regulatory tightening in the tech sector

CGB yields are now lower than corresponding U.S. treasury yields across the curve, ...

9. Yield Curves of Government Bonds
(In percent)

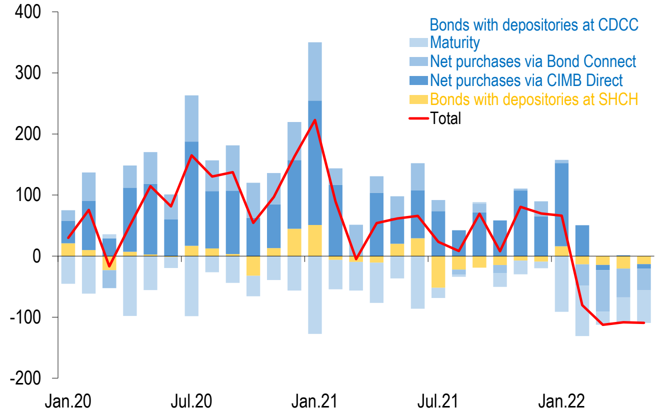


Sources: Bloomberg; and IMF staff calculations.

- The CGB yield curve has steepened this year as short-end interest rates have declined as a result of some monetary policy easing.
- Unlike other markets, long-end CGB yields appear well-anchored rather than move up along with rising U.S. treasury yields.

... reducing the incentive to hold CGBs and setting off bond outflows from China.

10. Foreign Fund Flows: Bonds
(In billions of USD)



Sources: CEIC; and IMF staff calculations.

- Nonresidents have reduced their holding of China's bonds for four straight months since February.
- While cumulative net bond outflows amounted to about 400 billion RMB, such outflows still accounted for only 0.3 percent of China's total outstanding bonds, or about 18 percent of cumulative net inflows in the preceding three years.

Chinese tech stocks started to recover on signals for a conclusion of regulatory tightening.

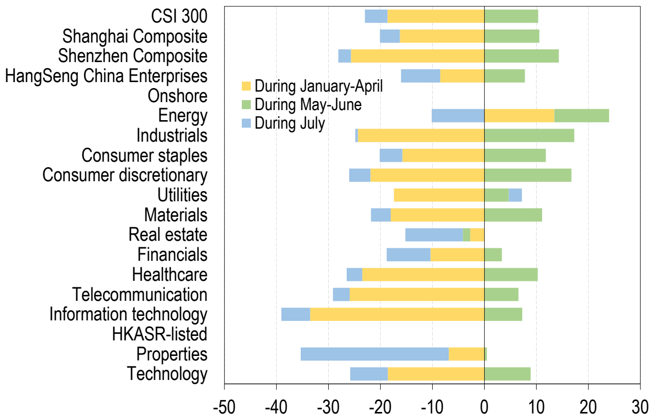
11. Equities Prices of Tech Companies
(End-2019 = 100; Based on prices in KD)

Sources: Bloomberg; and IMF staff calculations.

- Chinese authorities reportedly prepared to conclude investigations on Didi and accept Ant's application for a financial holding company license. Even though there has been no official confirmation, markets became optimistic that there would be no further regulatory tightening.
- Top Chinese policymakers repeatedly reiterated their support to the healthy development of the platform economy.

Chinese equities recovered in May-June but fell again in July due to concerns about renewed COVID outbreaks.

12. Change in Equity Total Return, 2022
(In percent; Relative to end-2021)



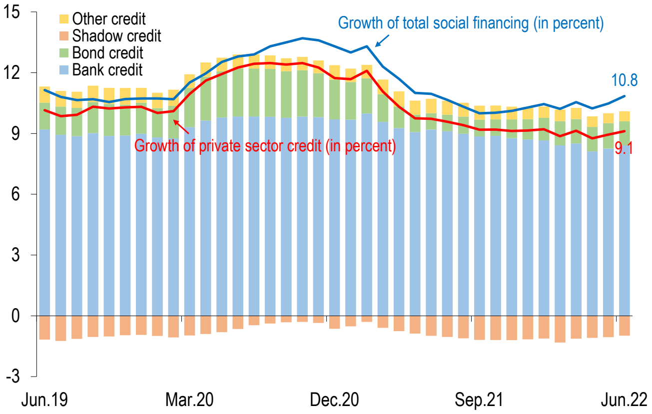
Sources: Bloomberg; and IMF staff calculations.

- Chinese equities still declined year-to-date across all sectors except for energy stocks, which benefit from higher energy prices. Stocks in the information technology, telecom and healthcare sectors have fallen the most year-to-date.
- While Chinese equities recovered across the board in May-June, real estate stocks continue to fall as financial stress of property developers has deepened.

Total social financing has picked up, but underlying credit demand appears weak

Overall credit growth has picked up; though, private sector credit growth only increased 9.1% y/y in June ...

13. Contribution to Private Sector Credit Growth
(In percentage points; Year-on-year)



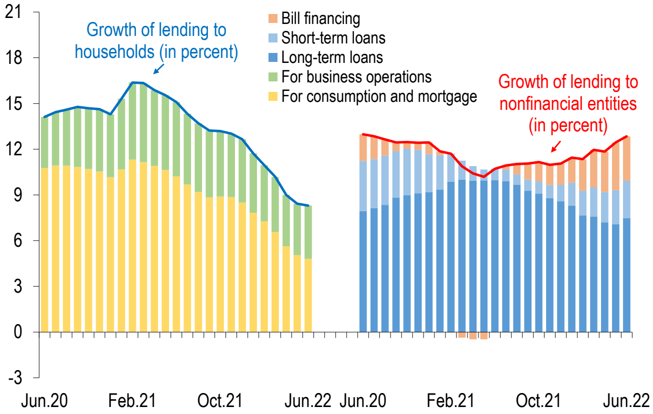
Sources: CEIC; and IMF staff calculations.

Note: Based on total social financing; private sector credit excludes government bond credit and equity financing. Hence, private sector credit include credit provided to state-owned enterprises and local government financing vehicles.

- The acceleration is total social financing growth was underpinned by front-loaded government bond issuance. In addition to moderating bank credit growth, the decline in shadow credit continues to weigh on overall private sector credit growth.

... as demand of households and businesses for longer-term credit, though improving in June, remains weak.

14. Contribution to Bank Lending Growth
(In percentage points; Year-on-year)



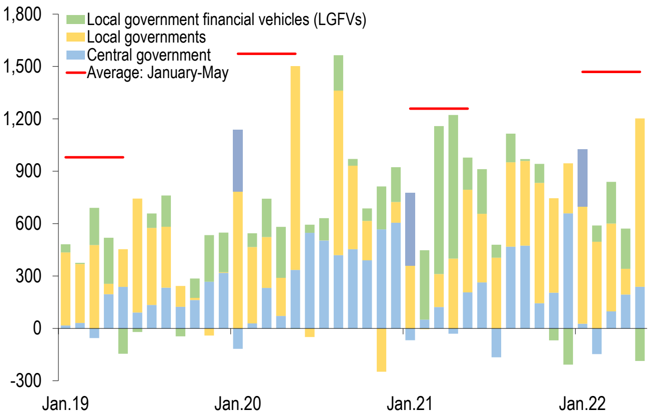
Sources: CEIC; and IMF staff estimates.

Note: Lending to nonfinancial entities, which would include government-linked entities such as state-owned enterprises and local government financial vehicles.

- Bank lending to households has slowed sharply, likely driven by weakening demand for mortgage financing. Meanwhile, bank loans to corporates have grown more slowly, and banks have shifted to boost bill financing to sustain their overall lending to corporates.

Meanwhile, bond issuance by the public sector has been relatively strong this year, largely driven by local governments.

15. Public Sector: Net Bond Issuance
(In billions of RMB)

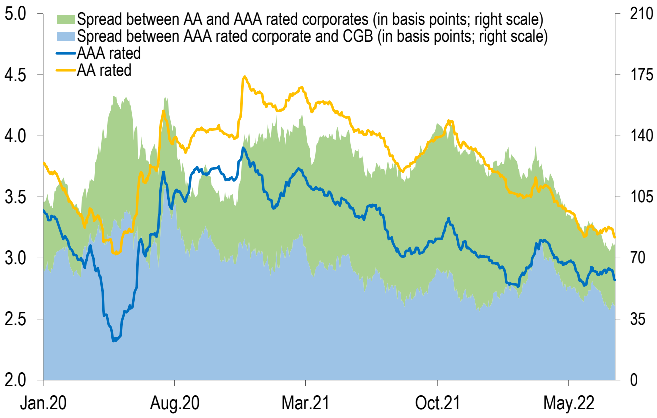


Sources: WIND; and IMF staff calculations.

- In the first five months, net issuance of CGBs, local government bonds (LGBs) and bonds issued by local government financing vehicles (LGFVs) amounted to about 0.4, 2.8 and 4.2 trillion RMB, respectively.
- Relative to last year, net government bond issuance was much larger, while LGFVs reduced their net bond issuance.

Despite property developers' ongoing distress, there is no sign of stress elsewhere in the onshore bond market, with corporate credit spreads narrowing further.

16. Nonfinancial Corporate Bond Yields, 3-year
(In percent)



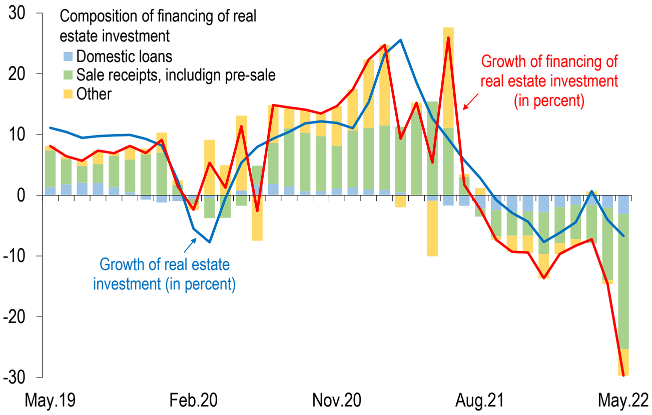
Sources: Bloomberg; and IMF staff estimates.

- Spreads between AAA and AA rated issuers, as well as spreads of lower-rated corporate bonds, have compressed in recent months, suggesting that the onshore credit market remains resilient.
- The compression of spreads may benefit from the wealth management product (WMP) reform, which helps boost the demand for credit bonds as high-yield WMPs and their underlying shadow credit dimmish.

Financial stress of property developers has deepened amid lockdowns

Financial stress of property developers deepened in May as lockdowns limited real estate transactions.

17. Real Estate Investment and Contribution to Its Financing
(Year-on-year; 3-month moving average)

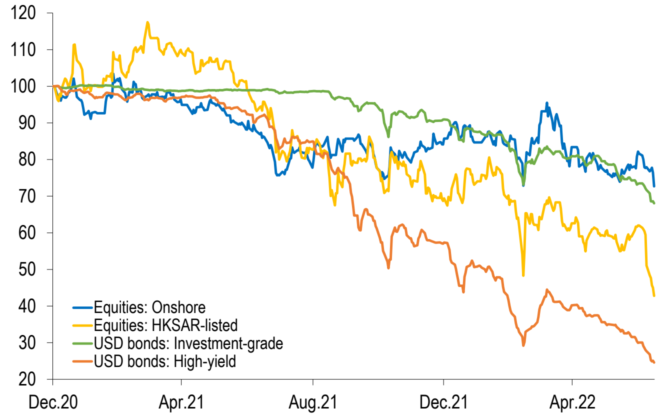


Sources: CEIC; and IMF staff calculations.

- Home sale receipts are an important funding source of property developers in recent years. A sharp decline in home sales during lockdowns exacerbated property developers' liquidity conditions.
- As discussed in April 2022 GFSR, such liquidity strains could be self-reinforcing as potential home buyers would avoid financially weak property developers, thus further intensifying their liquidity difficulty.

Stocks and offshore USD bonds of real estate firms continued to underperform ...

18. Real Estate Firms: Equity and Offshore USD Bond Prices
(End-2020 100; Based on prices in local currency)

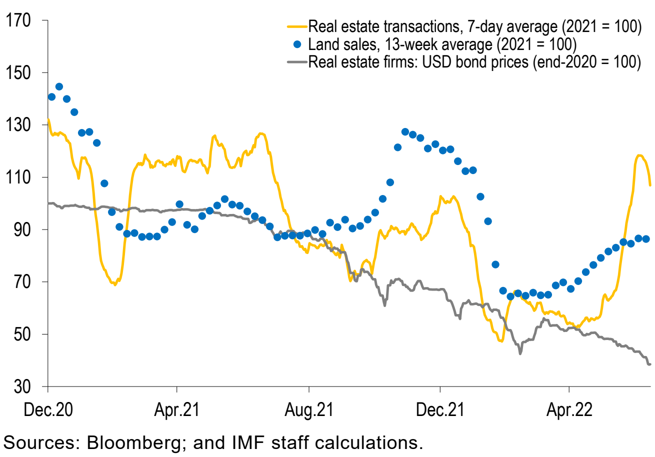


Sources: Bloomberg; WIND; and IMF staff calculations.

- Share prices of real estate firms have been on a declining trend since early April as falling home sales amid lockdowns exacerbated liquidity strains of property developers. Their USD bond prices similarly declined.
- Trading of many HKSAR-listed property developers continues being suspended as their financial statements have not been released.

... despite a sharp recovery in home sales in recent weeks after lockdowns were lifted, ...

19. Real Estate Transactions, Land Sales, and Offshore USD Bond Prices

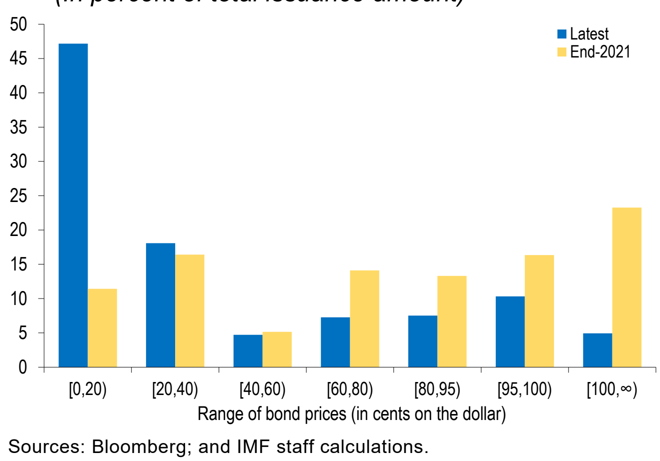


Sources: Bloomberg; and IMF staff calculations.

- Although home sales started improving in recent weeks, the pickup has been limited to higher-tiered cities. Furthermore, a few cities reported unusually high sales, which may not be sustained due to one-off sales related to settlement and/or non-commodity housing.
- Land sales by local governments appear to have stabilized, albeit at a lower level.

... with a large portion of offshore USD bonds currently being traded at significant discounts.

20. Price Distribution of Offshore USD Bonds Issued by Real Estate Firms
(In percent of total issuance amount)



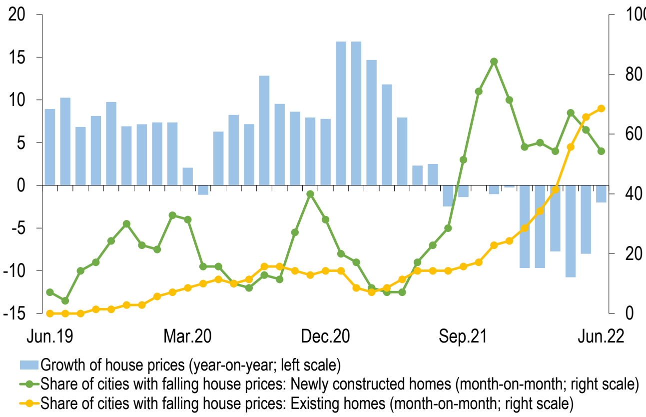
Sources: Bloomberg; and IMF staff calculations.

- Investors are pricing in debt restructurings for many property developers, some of which have defaulted on their bond payments and/or sought to modify their repayment schedule.
- More recently, market pressure started spreading to onshore bonds after a major property developer missed a payment.

The property sector's slump continued despite policy easing to boost home-buying demand

Overall house prices continued a declining trend, although the magnitude of price drops has been limited so far.

21. House Prices
(In percent)

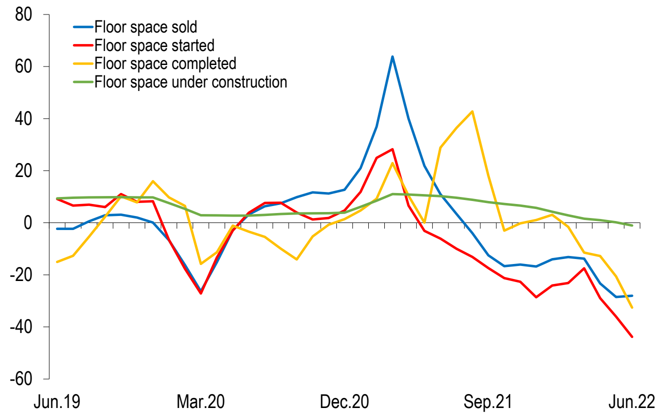


Sources: CEIC; and IMF staff calculations.

- Year-to-date, average house prices have been relatively stable for new homes but fallen by about 5 percent for existing home.
- Many local governments have rolled various measures to boost home-buying demand, including relaxing home purchase restrictions, lowering down-payment requirements (up to the nationwide minimum requirements), and providing subsidies for home purchases.

Housing sales and construction remain weak ...

22. Housing Sales and Construction
(In percent; Year-on-year; 3-month moving average

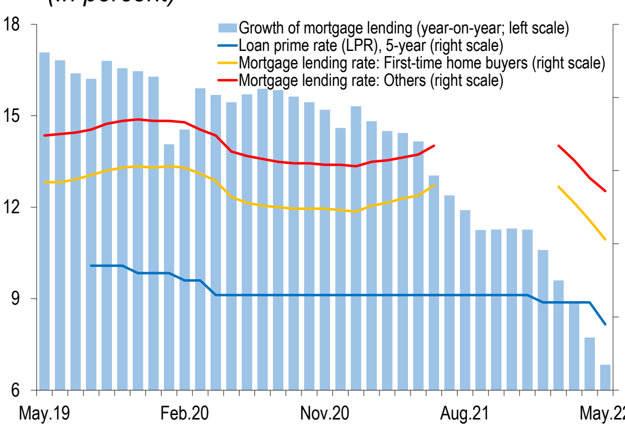


Sources: CEIC; and IMF staff calculations.

- Housing market conditions vary substantially across regions, with demand remaining relatively strong for top-tier cities.
- As home sales plummet, property developers lack incentives to start new projects, resulting in a decline in housing starts, with a negative impact on investment (for GDP) going forward.
- COVID-related lockdowns also temporarily affected housing sales and construction.

... despite various policy easing, which includes relaxations of home-buying restrictions and cuts of mortgage rates. Mortgage lending remains weak ...

23. Mortgage Lending
(In percent)

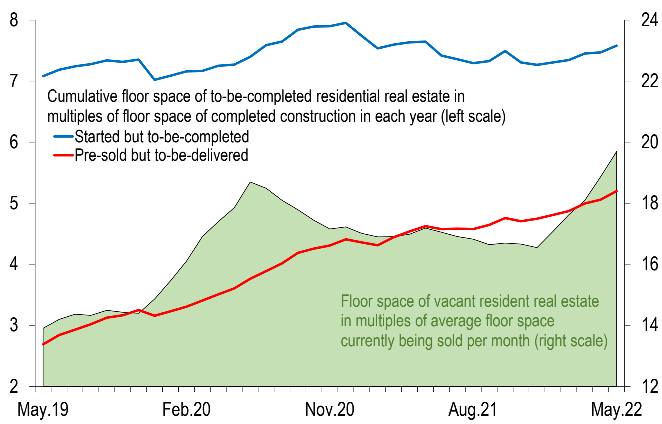


Sources: CEIC; and IMF staff calculations.

- The 5-year LPR, which is a benchmark for mortgage rates, was cut by 15 bps in May.
- In May, the floor of mortgage rates for first-time home buyers was also lowered to 20 bps below the 5-year LPR. Meanwhile, the floor of additional mortgages (e.g., for second homes) remains unchanged—i.e., 60 bps above the 5-year LPR.

... potentially due to concerns about the ability of property developers to finish construction, as well as dimmer prospects of jobs and income.

24. Uncompleted and Vacant Residential Real Estate



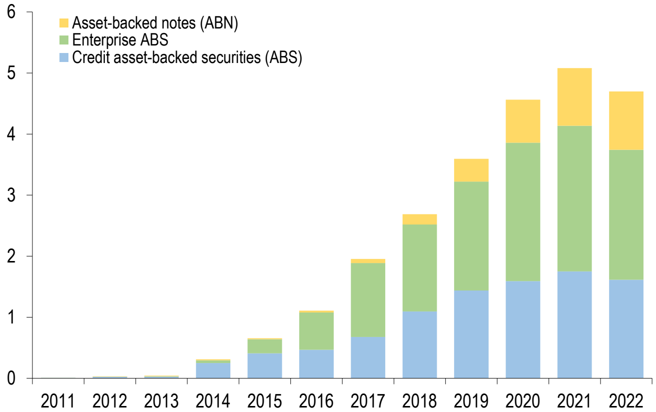
Sources: CEIC; and IMF staff estimates.

- The stock of unfinished, pre-sold housing remains large. It would take about 5 years to complete the construction, assuming no new housing starts.
- Meanwhile, the housing inventory (of existing or newly built homes) has increased in recent months. It would take about 20 months to clear the existing inventory, assuming no new houses entering the market.

Analytical feature: Securitization of real estate financing

The securitized products market is fragmented, with three different regulatory frameworks.

25. Outstanding Asset-backed Securities
(In trillions of RMB)

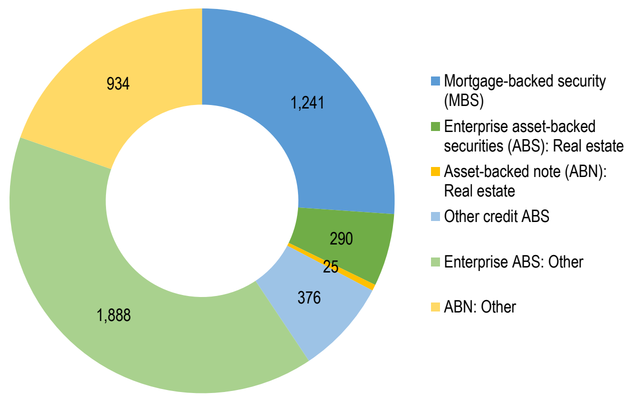


Sources: WIND; and IMF staff calculations.

- China has three types of ABS. First, the credit asset securitization scheme (regulated by the PBC and the CBIRC) allows financial institutions to issue credit ABS using a special purpose trust structure. Second, the asset-backed specific plan (regulated by the CSRC) enables securities firms to acquire underlying assets mostly from firms to issue enterprise ABS under the asset-backed specific plan scheme. Third, ABN could be issued by nonfinancial entities, essentially as secured loans (broadly similar to covered bonds).

The securitized products market is fragmented, with three different regulatory frameworks.

26. Composition of Asset-backed Securities
(In billions of RMB)

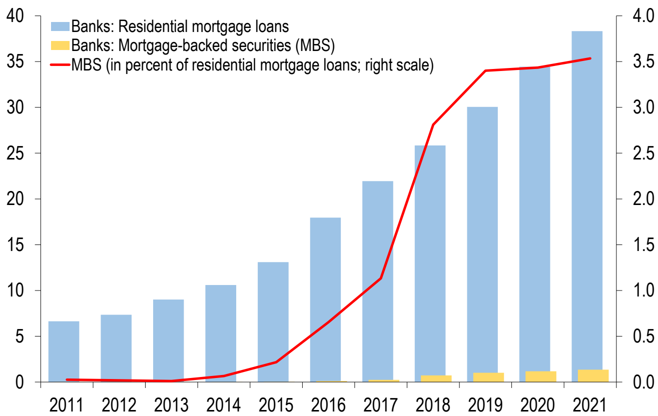


Sources: WIND; and IMF staff calculations.

- For securitization of real estate financing, MBS, which is issued by banks, is the largest component, accounting for almost 80 percent of credit ABS. Real estate firms also rely on enterprise ABS and ABN, which together account for about 10 percent of non-credit ABS.
- In China, securitization is based on the regulatory frameworks established by regulations rather than laws. Market participants noted potential legal risks, with the frameworks not being tested in courts.

MBS still do not serve as a core funding source for banks' mortgage lending.

27. Housing Finance
(In trillions of RMB)

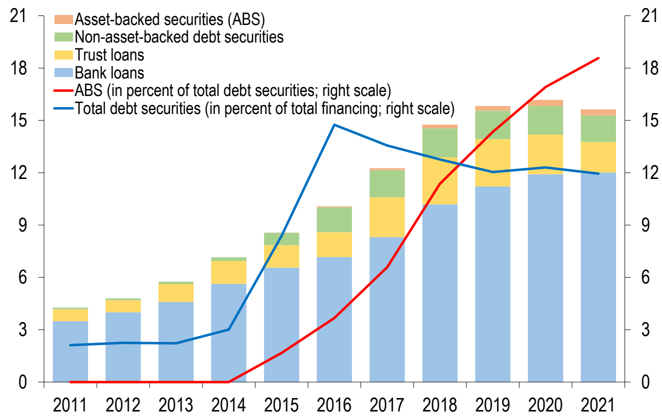


Sources: CEIC; and IMF staff calculations.

- As sales of pre-completion properties are common in China, about 20-30 percent of MBS are estimated to have unfinished housing as underlying assets [Fitch], broadly similar to the share of unfinished housing in total residential mortgages [JP Morgan].

Real estate firms also raise market funding by issuing ABS.

28. Onshore Financing of Real Estate Firms
(In trillions of RMB; Based on onshore financing only)



Sources: CEIC; WIND; and IMF staff calculations.

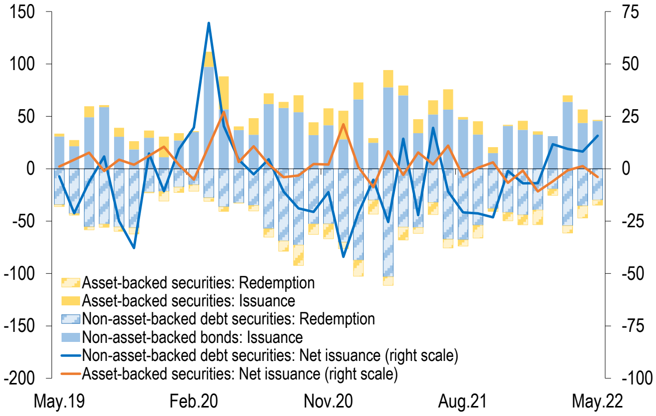
Note: ABS issued by real estate firms include both enterprises ABS and asset-backed notes (ABN).

- Debt securities account for about 12 percent of real estate firms' total financing. The proportion of ABS in debt securities issuance has increased to 19 percent.
- Some banks reportedly issued MBS when exceeding their (on-balance sheet) property-related lending caps.

Analytical feature: Securitization of real estate financing

While some real estate firms can still raise funds via onshore bond issuance, net issuance of ABS has been largely negative since November 2021.

29. Net Issuance of Debt Securities Issued by Real Estate Firms
(In billions of RMB)



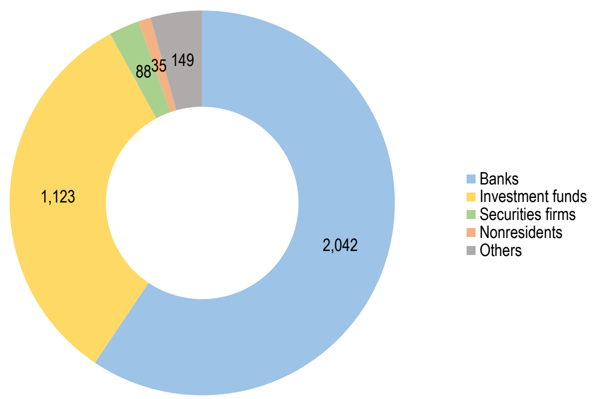
Sources: CEIC; and IMF staff calculations.

Note: ABS issued by real estate firms include both enterprises ABS and asset-backed notes (ABN).

- In 2021H2, real estate firms saw negative net issuance of debt securities amid growing concerns about their financial stress.
- In recent months, strong policy signals to maintain financing to financially sound real estate firms have enabled them to tap funding in the onshore bond market again. However, ABS financing remains limited.

Banks and investment funds—including WMPs—are the main ABS holders, accounting for about 59 and 33 percent of total ABS, respectively.

30. Composition of Holders of Assets-backed Securities, May 2022
(In billions of RMB)



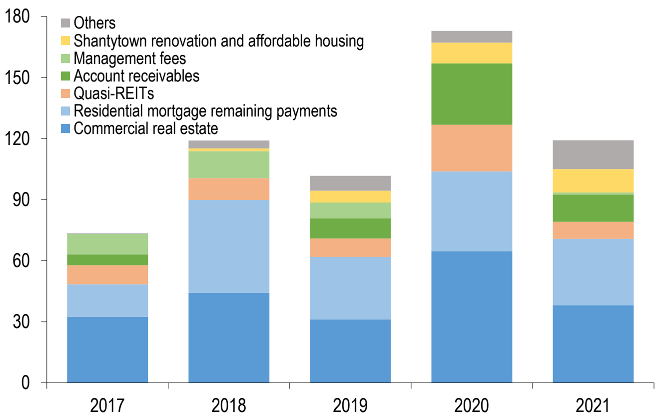
Sources: CEIC; and IMF staff calculations.

Note: Based on available data of CDCC and SHCH.

- Banks issue credit ABS for fund-raising purposes. Originating banks thus typically retain credit risk by holding the non-senior tranche.
- Banks' large cross-holding of credit ABS may strengthen connectedness across banks.
- A materialization of credit risk in the ABS space could interact with existing vulnerabilities in the WMP sector.

Commercial real estate and residential mortgage remaining payments serve as the main underlying assets for ABS issued by real estate firms.

31. Underlying Assets of Enterprise ABSs Issued by Real Estate Firms
(In billions of RMB)

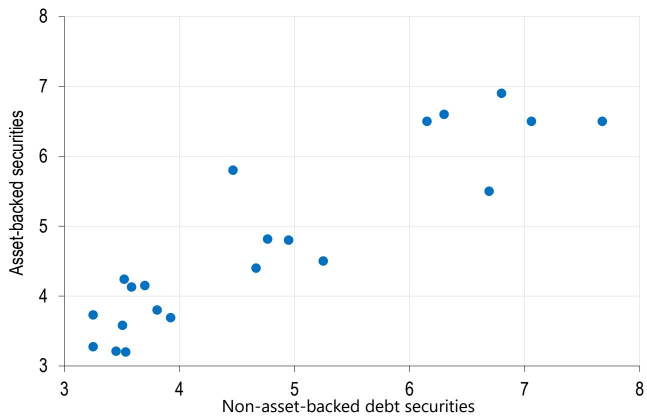


Sources: WIND; and IMF staff calculations.

- Enterprise ABS can also be exposed to unfinished housing risk, as real estate firms securitize residential mortgage remaining payments.

ABS appear to provide real estate firms with an alternative funding channel, but such collateral-backed borrowing does not offer more favorable funding costs.

32. Issuance Yields of AAA-rated Debt Securities Issued by Real Estate Firms, 2021
(In percent)



Sources: WIND; and IMF staff calculations.

- Issuance yields vary substantially, potentially based on market perception of issuers' creditworthiness (and not on credit ratings). Investors do not appear to view that securitization offers additional protection.