GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

# China Monitor

WEDNESDAY, SEPTEMBER 15, 2021

## CHINA MONITOR

This is an inaugural China Monitor. The Monitor aims to provide a regular update on the policy setting, credit conditions and market trends in China. The Monitor also include analytical features, which offer a more in-depth analysis of selected macrofinancial issues related to China.

## KEY HIGHLIGHTS

**Policy setting.** The monetary policy stance is moderately tighter in 2021 than last year given a slowdown in credit growth. The previous policy tightening bias dissipated following a surprise reduction of the reserve requirement ratio (RRR) by the People's Bank of China (PBC) in July. Earlier, markets were concerned about tight liquidity conditions stemming from expected larger-than-average government bond issuance in 2021H2. Since the RRR cut, bond yields have declined. The PBC continues to manage interbank liquidity to keep short-end interbank repo rates closer to its policy rate. In its recent communication, the PBC plans to provide more targeted support to certain sectors (including small and medium-sized enterprises) while signaling for no substantial easing in the near term. The exchange has fluctuated around 6.5 RMB per USD in recent months, with no significant deviations of daily RMB fixing from market consensus.

**Credit conditions.** Credit growth has moderated, mainly driven by the decline in shadow credit and the slowdown in corporate bond financing. Following a series of state-owned enterprise (SOE) defaults in late 2020, corporate credit conditions have tightened, with the tightening more pronounced for firms with weak credit ratings and in provinces with weaker public finances. Onshore credit spreads between AAA and AA rated issuers have widened since late 2020.

**Market trends.** ***Chinese equities*** in certain sectors have declined significantly since their 2021 height in February, following the regulatory tightening. Chinese authorities started tightening measures to address antitrust concerns in February and further intensified with multiple measures on the tech sector in July. Recent regulatory tightening has been associated with a multitude of goals, including tackling previously neglected competition issues and data security concerns in the tech sector, or achieving "common prosperity". With greater regulatory scrutiny, overseas equity fund-raising activity could further migrate to mainland China and Hong Kong SAR, with Shanghai's STAR board offering relatively attractive valuation. In recent months, markets have been concerned about China Huarong (a state-owned asset management company) and Evergrande (one of the largest and most leveraged property developers). ***China Huarong*** released its 2020 financial statement and announced a recapitalization plan, leading to a recovery of its bond prices. On the other hand, ***Evergrande*** continues facing significant market pressure given rising concerns around its liquidity conditions.

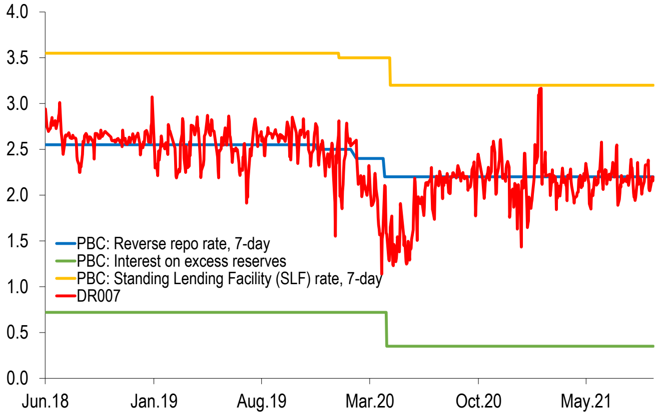
**Analytical feature.** This Monitor **reviews financial vulnerabilities in the property sector**, which remain elevated. Property prices remain on an upward trend. However, real estate activity started cooling off on the back of policy-induced tighter financing conditions to the property sectors. Many property developers are financially weak, with their earnings less than interest expense; they also face liquidity risk that could materialize if they become unable to meet their refinancing needs. Reflecting these concerns, about 10 percent of offshore bonds issued by property developers are traded with significant discounts.

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

## Monetary Policy Stance Shifted Toward an Easing Bias Following a Surprise RRR Cut in July

*The policy rates have remained unchanged since early 2020 at both the short end …*

### 1. Short-term Policy and Market Rates
*(In percent)*

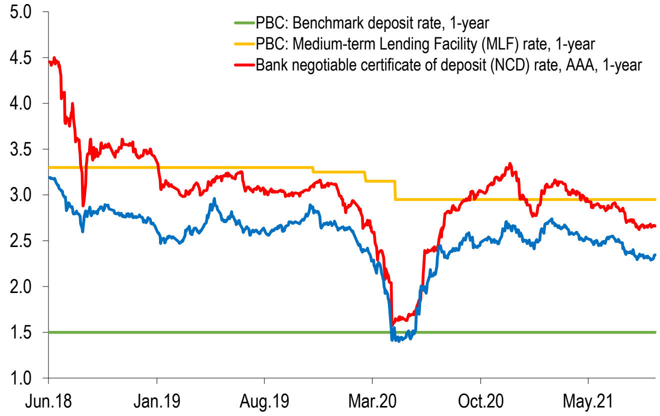



Sources: Bloomberg; and IMF staff calculations.

- The 7-day reverse repo rate was cut to 3.2 percent in March 2020.
- Since January 2021, the PBC has managed interbank liquidity to keep the 7-day interbank repo rate (DR007) around the PBC's 7-day reverse repo rate.

*… and the longer end.*

### 2. Medium-term Policy and Market Rates
*(In percent)*

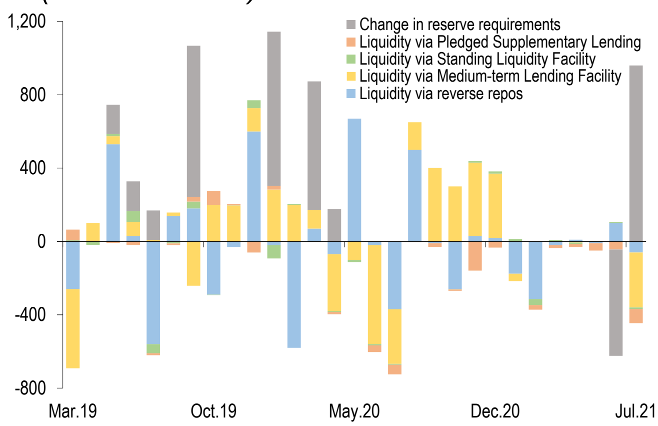



Sources: Bloomberg; and IMF staff calculations.

- The 1-year MLF rate was cut to 2.95 percent in April 2020. The demand for MLF funding remained strong in August 2021 despite the MLF rate higher than the bank NCD rate.
- The PBC rolled over almost all MLF funds that matured in August 2021 (600 out of 700 billon RMB).
- The 1-year Loan Prime Rate has remained at 3.85 percent in April 2020.

*In July 2021, the PBC lowered the overall reserve requirement ratio (RRR) by 0.5 percentage point, releasing liquidity of about 1 trillion RMB.*

### 3. PBC's Selected Liquidity Measures
*(In billions of RMB)*

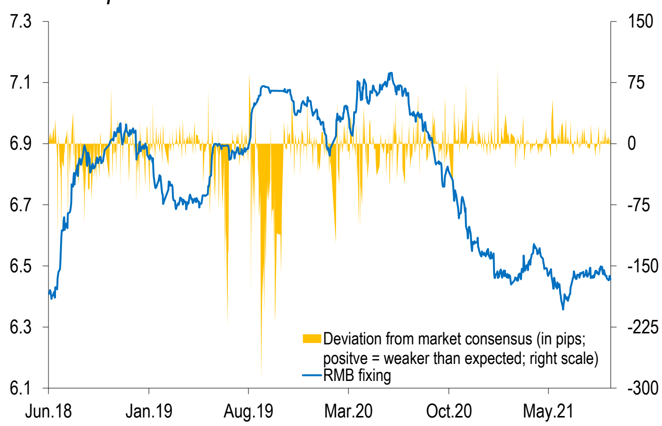



Sources: CEIC; and IMF staff calculations.

- In June 2021, the foreign-currency RRR was raised from 5 to 7 percent, withdrawing liquidity of about 580 billion RMB.
- In terms of market operations, the PBC has generally not provided additional liquidity since February 2021 except around the month-end period to alleviate liquidity pressures.

*The RMB has been relative stable since early 2021, fluctuating around 6.5 RMB per USD.*

### 4. RMB Fixing
*RMB per USD*



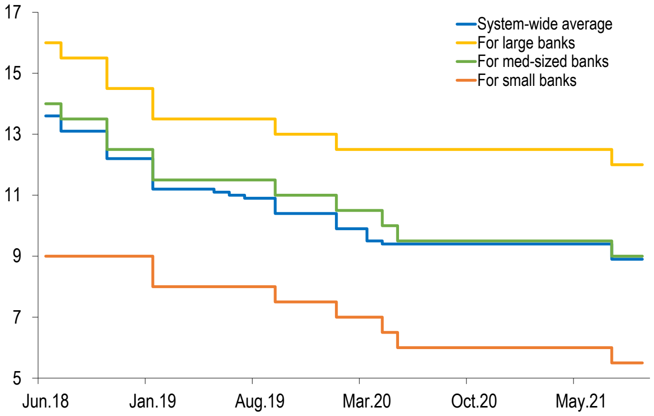

Sources: Bloomberg; and IMF staff calculations.

- The deviation of RMB fixing from market consensus has been relatively small in recent months.

## Sovereign Debt Market: A Surprise RRR Cut Resulted in Falling Bond Yields

*Market participants were largely surprised by the PBC's RRR cut in July 2021.*

**5. Banks' Reserve Requirements for RMB Deposits**
*(In percent)*

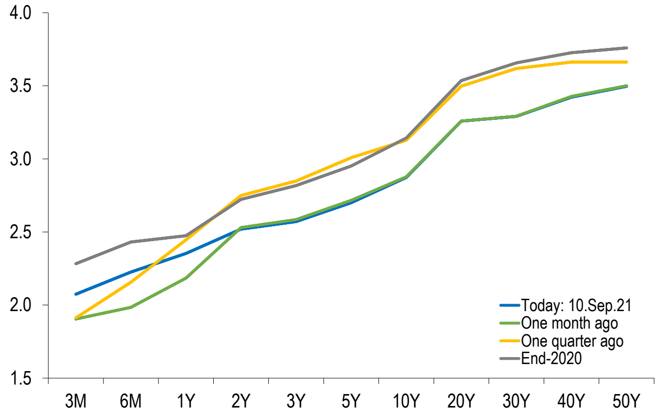



Sources: CEIC; and IMF staff calculations.

- This RRR cut was broad-based as opposed to targeted, which would apply only to banks meeting certain criteria.

*Bond yields have declined following the surprise RRR cut, which effectively removed a policy tightening bias.*

**6. Yield Curve of Central Government Bonds**
*(In percent)*

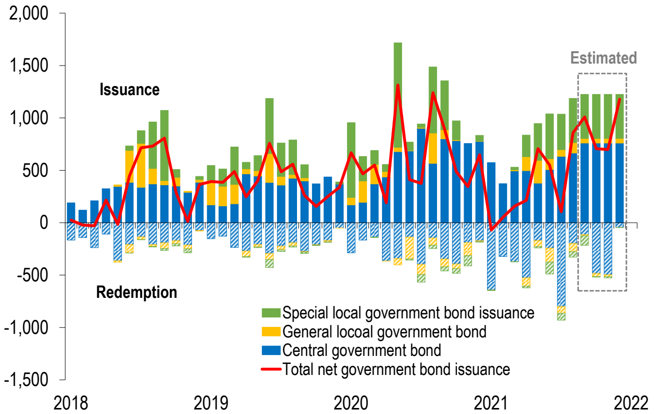



Sources: Bloomberg; and IMF staff calculations.

- Prior to the RRR cut, markets were concerned about relatively tight liquidity conditions due to expected larger-than-average government bond issuance in 2021H2.

*The issuance of both central and local governments has lagged the budget plan announced in March 2021.*

**7. Government Bond Issuance and Redemption**
*(In billions of RMB)*



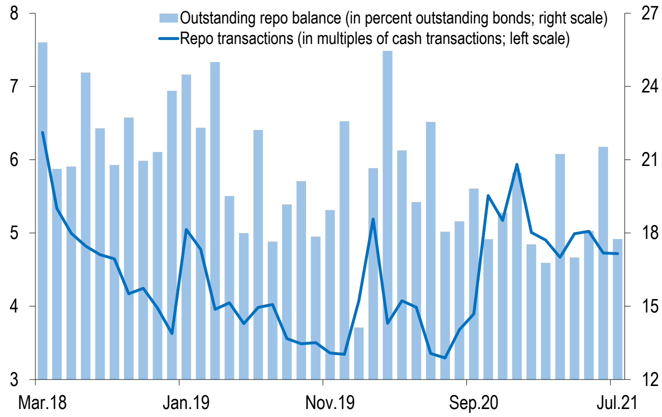

Sources: WIND; and IMF staff calculations.

Note: The amount of central government bond issuances is based on the budgeted fiscal balance figure. The amount of local government bond issuances is based on the issuance quotas.

- If the bond issuance is fully carried out in line with the budget, the average issuance of government bonds would amount to about 1.2 trillion RMB each month for the rest of 2021.

*The level of leverage in the bond market has remained broadly stable in recent months.*

**8. Interbank Bond Market: Cash and Repo Transactions**



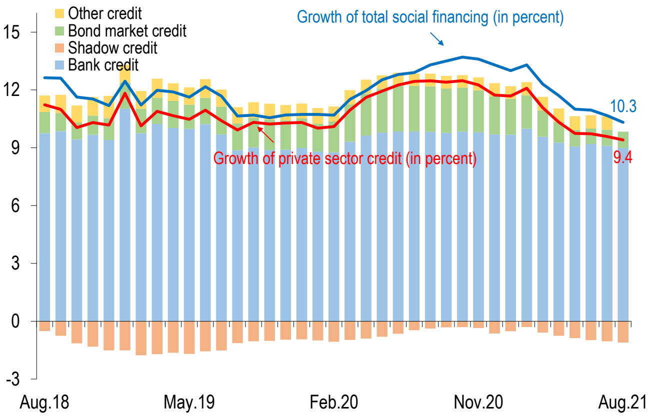

Sources: CEIC; and IMF staff calculations.

- In early 2021, the PBC withdrew liquidity sharply following some concern about greater risk-taking in the bond market (i.e., using repo to fund bond investment).

## Overall Credit Growth Has Moderated, with Some Corporate Borrowers Facing Tighter Credit Conditions Following a Weakening of Perceived Implicit Guarantees

*Credit growth has moderated, with private sector credit growing 9.4 percent y/y in August.*

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



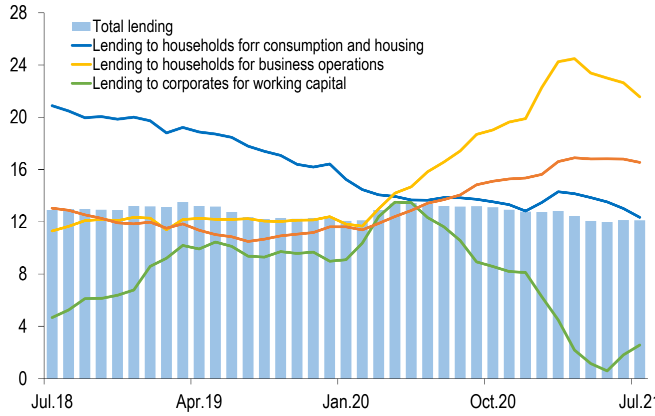

Sources: CEIC; and IMF staff calculations.

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

- The credit growth slowdown has been driven by the decline in shadow credit (partly, due to the ongoing asset management reform) and the moderation in bond market financing.

*Within bank lending, lending to corporates for working capital has slowed significantly.*

**10. Growth of Bank Lending to Household and Corporates**
*(In percent; Year-on-year)*



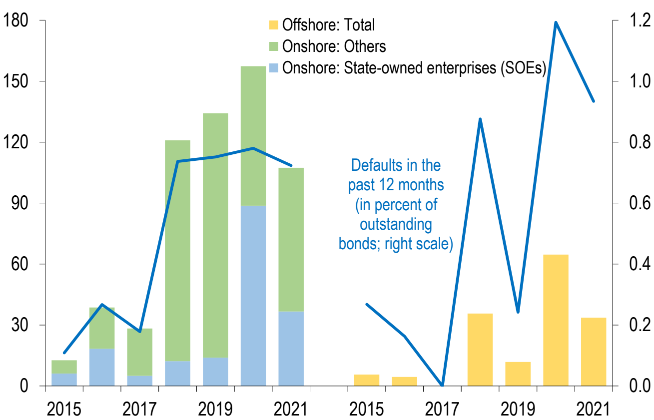

Sources: CEIC; and IMF staff calculations.

Note: Corporates cover nonfinancial enterprises, including government agencies. Lending to corporates for working capital include short-term loans, bill financing, and advance. Lending to corporates for investment include medium- and long-term loans and financial lease.

- Lending to households for business operations remains strong; there are some concerns that such lending has helped fund property purchases.
- Lending to the property sector has also moderated due to the policy tightening (see below).

*Corporate bond defaults have risen in recent years, …*

**11. Corporate Bond Defaults**
*(In billions of RMB)*



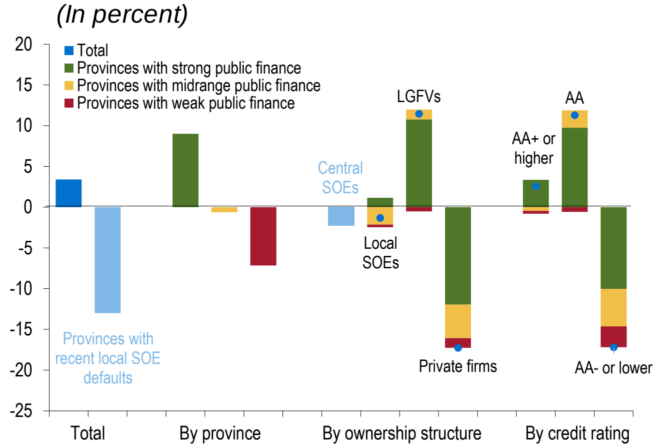

Sources: Bloomberg; WIND; and IMF staff estimates.

Note: The 2021 default figures are as of August. The offshore default figures include defaults of nonbank financial institutions.

- In the onshore market, unexpected SOE defaults in late 2020 prompted markets to reassess the assumption of implicit guarantees for state-owned entities.

*… resulting in a tightening of corporate credit conditions for some borrowers.*

**12. Change in Outstanding Corporate Bonds by Selected Characteristics, 2020Q3-2021Q2**
*(In percent)*




Sources: WIND; and IMF staff estimates.

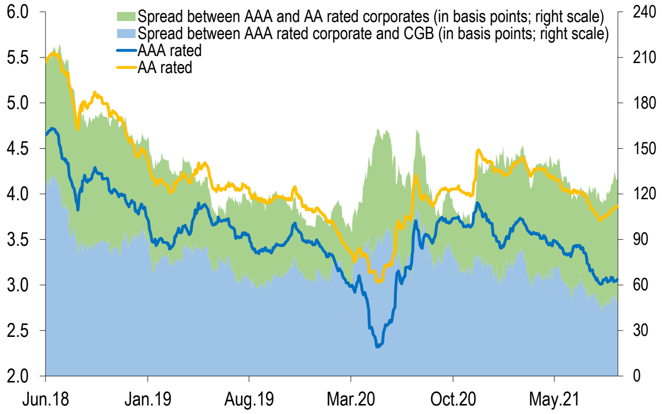
Note: SOE = state-owned enterprises; LGFV = local government financing vehicle.

- The tightening of credit conditions is more pronounced for firms with weak credit ratings and in provinces with weaker public finances.

## Greater Credit Risk Differentiation of Bonds Issuers Has Resulted in Wider Credit Spreads and More Credit Rating Downgrades

*Corporate credit spreads between AAA and AA rated issuers have remained wide following SOE defaults in late 2020.*

**13. Onshore Nonfinancial Corporate Bond Yields, 3-year**
*(In percent)*

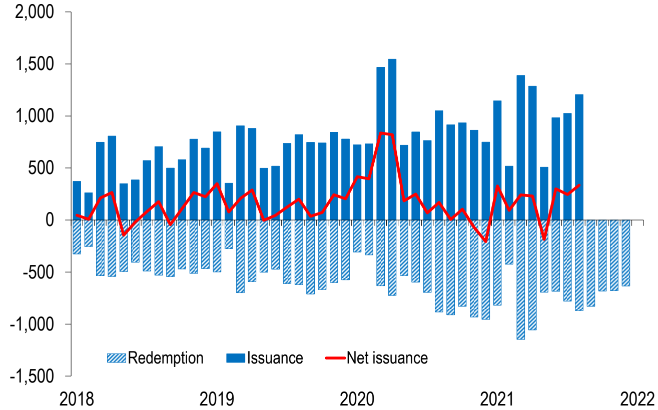



Sources: Bloomberg; and IMF staff calculations.

- Meanwhile, AAA rated corporates have enjoyed more favorable funding costs, with the narrowing spreads relative to CGB yields.

*Meanwhile, the net issuance of corporate bonds has remained positive in recent months after a contraction of bond market credit in May 2021.*

**14. Onshore Nonfinancial Corporate Bond Issuance and Redemption**
*(In billions of RMB)*

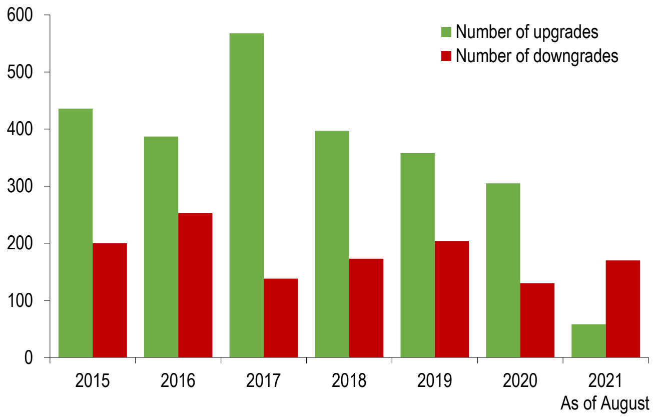



Sources: WIND; and IMF staff calculations.

- About 2.8 trillion RMB of corporate bonds set to mature in the remaining 2021, pointing to liquidity risk of financially weak borrowers that may find it more difficult to tap market funding.

*In the onshore market, greater credit risk differentiation is emerging.*

**15. Onshore Bond Issuers: Changes in Credit Rating and Outlook**

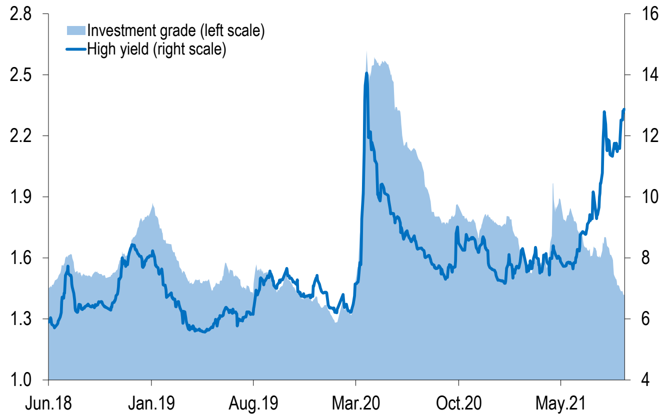



Sources: WIND; and IMF staff calculations.

- Market perception of weakening implicit guarantees and authorities' efforts to develop a high-yield bond market segment contribute to greater credit risk differentiation.
- More recently, the mandatory requirement for issuers to obtain a credit rating was removed, bringing China more in line with international practices.

*In the offshore market, spreads of Chinese high-yield credit have widened sharply since June 2021.*

**16. Offshore USD Credit Spreads**
*(In percentage points; Based on option-adjusted spread relative to U.S. Treasury)*



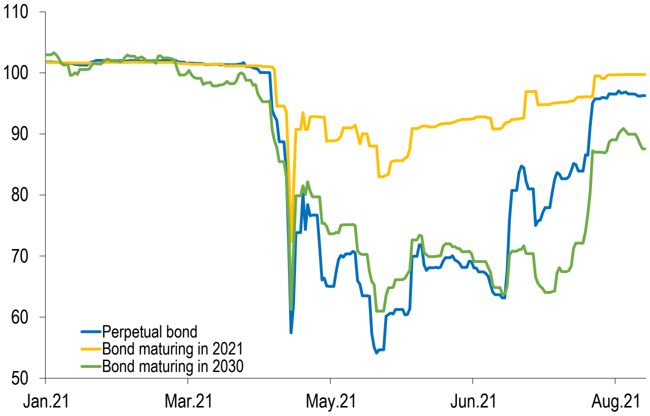

Sources: Bloomberg; and IMF staff calculations.

- The widening has been largely driven by Evergrande (one of the largest and most leveraged property developers in China).
- More recently, stress at Evergrande started spilling over to other offshore high-yield property developers.

## Some Highly Leveraged Borrowers Are Facing Significant Stress

*Huarong came under pressure in April after failing to publish its 2020 financial statement.*

**17. China Huarong: Selected Offshore USD Bonds Prices**
*(In cents on the dollar)*

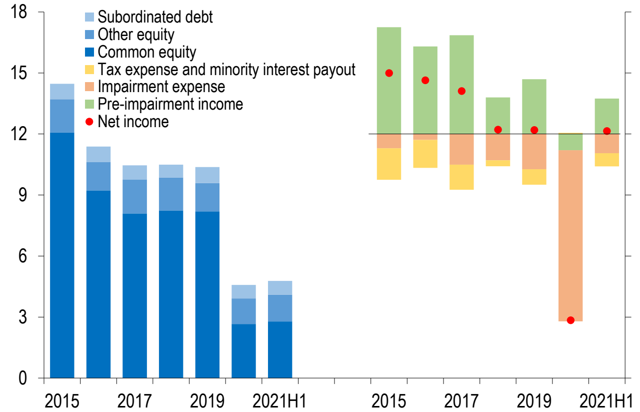



Sources: Bloomberg; and IMF staff calculations.

- Huarong's bond prices have recovered markedly in August after a recapitalization plan was announced.
- Huarong is the largest (state-owned) asset management company in China. It was initially set up to acquire bad debt from banks but has subsequently expanded into a large financial conglomerate.

*Huarong booked a substantial loss in 2020, resulting in a sharp decline in its equity.*

**18. China Huarong: Capital and Earnings**
*(In percent of total assets)*




Sources: SNL; and IMF staff calculations.

- Currently, Huarong is working with a group of strategic investors led by CITIC (a state-owned firm) on the recapitalization plan. Huarong also announced its plan to divest its non-core subsidiaries.

*Evergrande has been facing renewed stress in recent months as its creditors become increasingly concerned about its liquidity situation.*

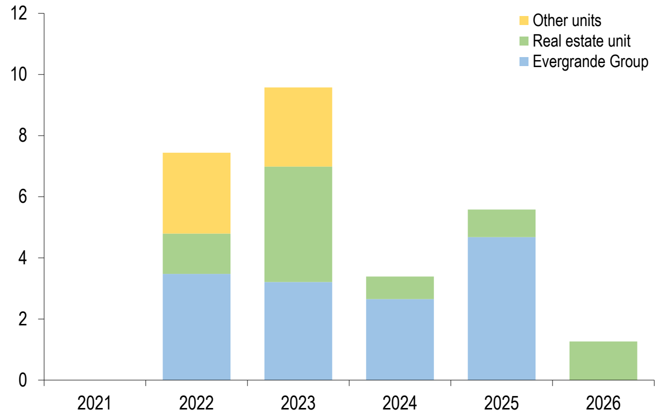
**19. Evergrande: Share and Offshore USD Bond Prices**
*(In cents on the dollar)*


Sources: Bloomberg; and IMF staff calculations.

- Evergrande is one of the largest (private) property developers.
- Given the rise in the number of lawsuits against Evergrande, all cases are now centralized and will be handled by the Guangzhou court.

*Evergrande does not have bonds maturing in the remaining 2021. However, its accounts payable (to its suppliers) have increased sharply.*

**20. Evergrande: Maturing Bonds**
*(In billions of USD)*




Sources: Bloomberg; and IMF staff calculations.
Note: Including both onshore and offshore bonds.

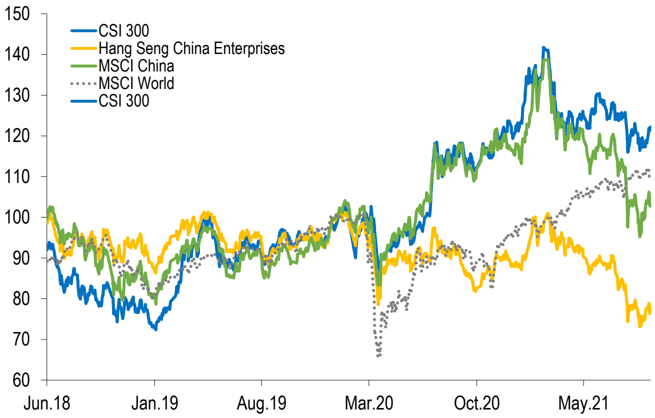
- In the past two weeks, all major rating agencies downgraded Evergrande, noting a significant default risk. Reportedly, Evergrande last week informed two banks that it plans to delay interest payments.

## Equities Declined on the Back of Regulatory Tightening

*Chinese equities have declined significantly following the regulatory tightening.*

### 21. Equity Prices

*(End-2019 = 100; Based on prices in RMB)*



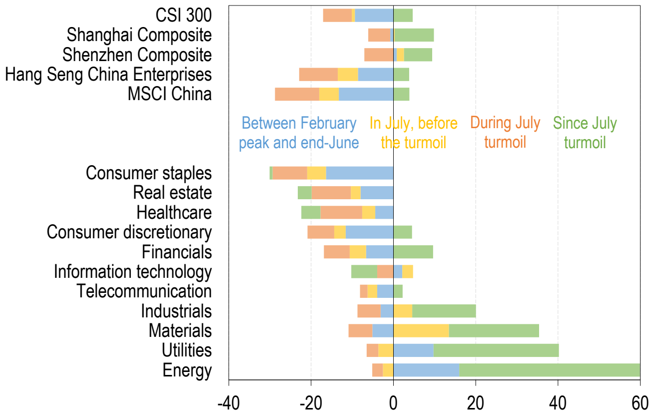

Sources: Bloomberg; and IMF staff calculations.

- The regulatory tightening started with addressing antitrust concerns in February 2021 and further intensified in multiple tech sectors in July.
- Recent regulatory tightening aims at tackling data security concerns and achieving "common prosperity".

*Equities in the consumer, real estate, and healthcare sectors have been more negatively affected.*

### 22. Change in Total Equity Return, Since February Peak

*(In percent; Relative to February 10, 2021)*

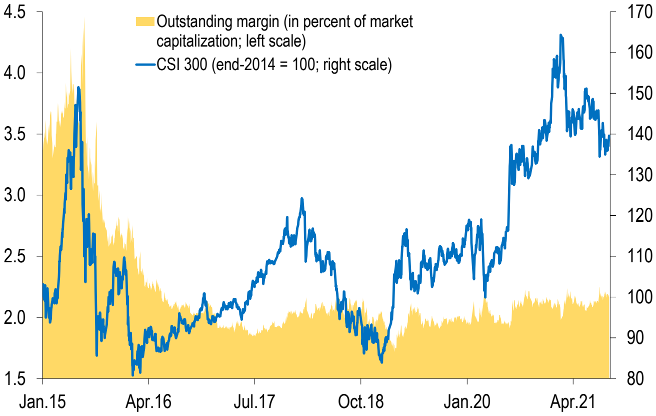



Sources: Bloomberg; and IMF staff calculations.

- Equities in the energy, utilities, materials, and industrials sectors have outperformed. These sectors appear to be less susceptible to the recent regulatory tightening.

*Even though stock prices declined sharply and remain volatile, the market rout did not turn into a significant financial stress given relatively limited risk-taking.*

### 23. Margin Lending for Stock Purchases and Equity Prices



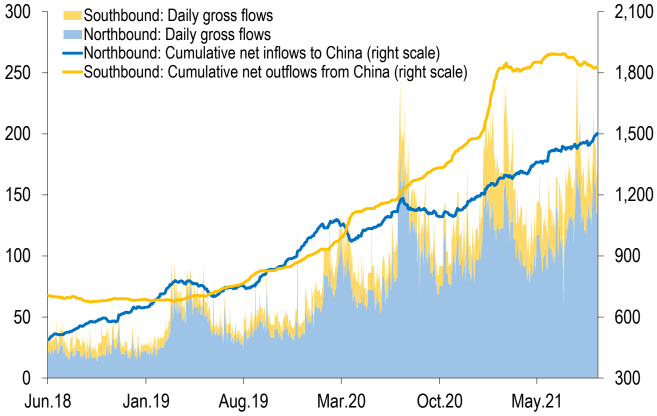

Sources: Bloomberg; and IMF staff calculations.

- The level of leverage in the stock market has remained relatively low, especially compared with the 2015 level when a stock market crash occurred.

*Foreign funds continue to flow into China via the Northbound Stock Connect scheme, albeit at a slower pace following the recent regulatory tightening.*

### 24. Stock Connect Flows

*(In billions of RMB)*



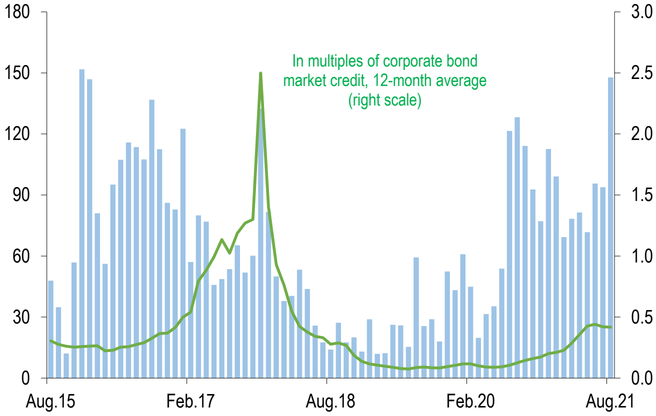

Sources: Bloomberg; and IMF staff calculations.

- At the same time, Chinese investors appear to repatriate their investment in Hong Kong SAR via the Southbound Stock Connect scheme.

## More Equity Fund-raising Activities Could Move to Mainland and Hong Kong SAR

*Equity financing is an important source of corporate financing.*

**25. Nonfinancial Firms: Equity Financing**
*(In billions of RMB; Based on total social financing)*

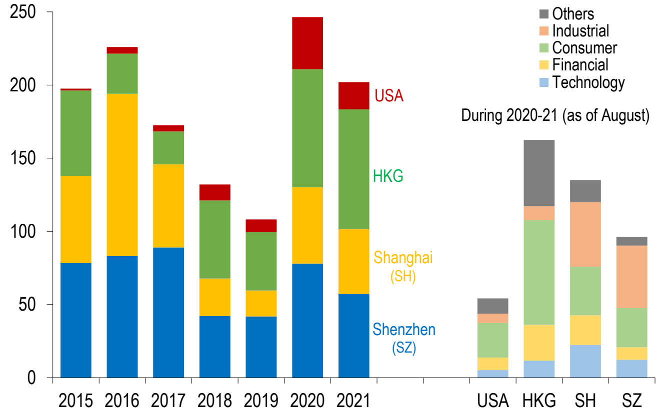



Sources: CEIC; and IMF staff calculations.

- Recently, onshore equity financing amounts to around half of onshore corporate bond financing.

*Chinese firms mainly rely on exchanges in mainland (i.e., Shanghai and Shenzhen), Hong Kong SAR, and the United States to complete their equity fund-raising.*

**26. Equity Fund-Raising**
*(In billions of USD)*



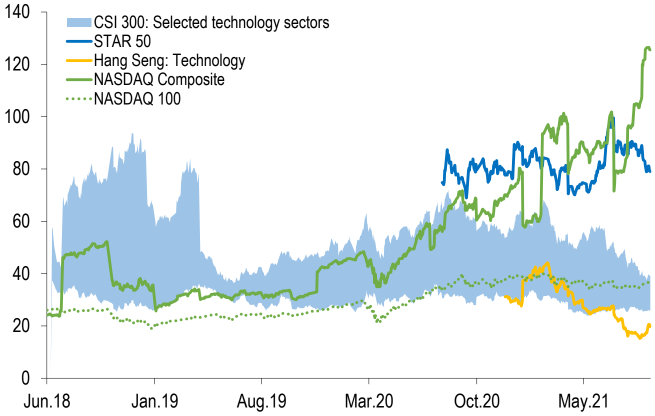

Sources: Bloomberg; and IMF staff calculations.

Note: Financial also includes real estate; others mainly include telecommunication and utilities.

- During 2020-21, Hong Kong SAR is a main venue for equity fund-raising for firms in the consumer and real estate sectors, while activities in Shanghai and Shenzhen are tilted towards industrial firms.

*Valuation of firms listed on Shanghai's STAR board is attractive in comparison with NASDAQ; these firms tend to be "hard tech" firms.*

**27. Technology Stocks: Price to Earnings**
*(In multiples)*



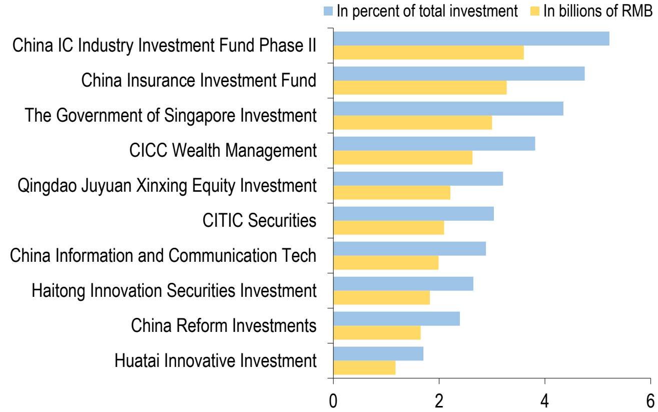

Sources: Bloomberg; and IMF staff calculations.

Note: CSI 300's selected technology sectors include: healthcare, information technology, and telecommunication.

- IPOs in the United States remain attractive for Chinese firms in part because of the relatively high valuation.
- Meanwhile, valuation of tech firms listed in Hong Kong SAR is markedly lower as they are more concentrated in the sectors under the recent regulatory scrutiny.

*Newly listed firms on the STAR board have benefited from investment from China's state-owned institutional investors.*

**28. Shanghai STAR Board: Top Strategic Investors' Investment in Public Offerings**

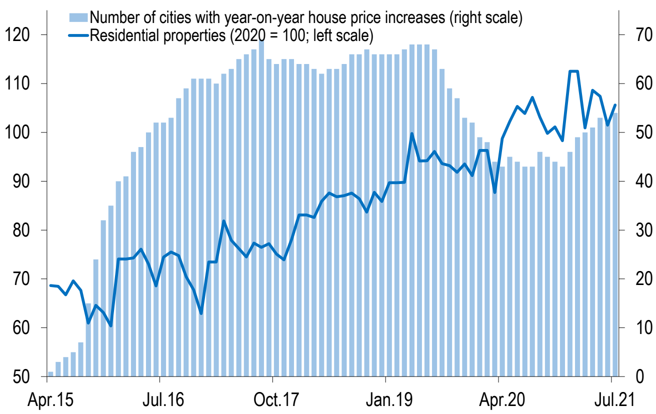



Sources: WIND; and IMF staff calculations.

## Analytical Feature: Financial Vulnerabilities Remain Elevated in the Property Sector

*Property prices in China remain on an upward trend.*

### 29. Residential Property Prices



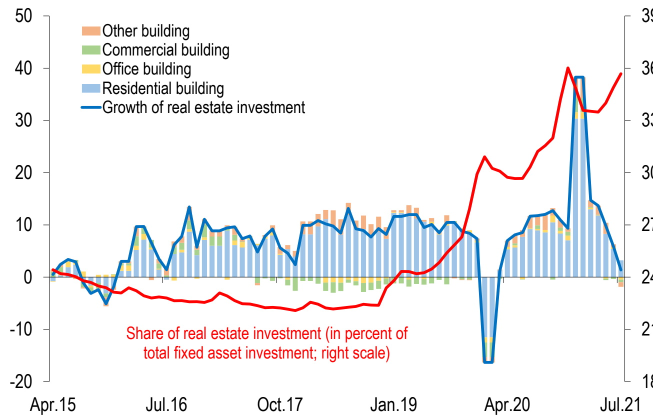

Sources: CEIC; and IMF staff calculations.

- More recently, slightly more than 50 cities (out of 70) saw rising property prices.
- However, tier-1 city property markets appear to show signs of cooling in recent months. For example, secondary market transactions in Shenzhen dropped 70 percent y/y in August after the introduction of official reference prices instituted in February.

*Real estate investment started to moderate on the back of tighter financing conditions, …*

### 30. Real Estate Investment

*(In percent; Year-on-year)*



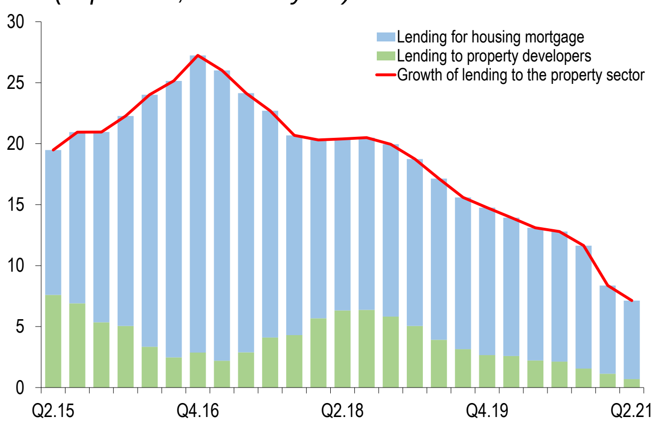

Sources: CEIC; and IMF staff calculations.

- Real estate investment is dominated by housing investment.
- The policy tightening from 2020Q3 has induced tighter financing conditions. The measures include constraining the borrowing of financially weak property developers ("the three red lines policy") and limiting bank lending to property developers and for mortgages.

*… as suggested by a slowdown in bank lending …*

### 31. Bank Lending to the Property Sector

*(In percent; Year-on-year)*



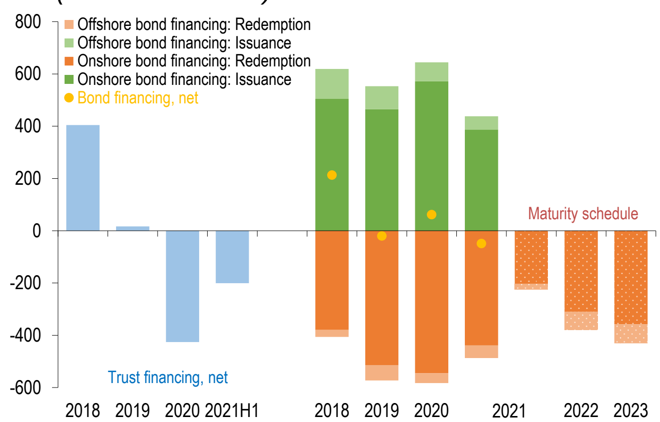

Sources: CEIC; and IMF staff calculations.

- Bank lending to the property sector has already moderated prior to the three red lines policy.
- As of 2021Q2, bank lending to property developers amounted to 12.3 trillion RMB, and bank lending for mortgages amounted to 38.5 trillion RMB.
- In addition, many local governments have implemented additional measures to contain real estate transactions (e.g., holding period requirement and buyers' eligibility).

*… and nonbank financing to the property sector.*

### 32. Property Developers: Nonbank Financing

*(In billions of RMB)*




Sources: CEIC; WIND; and IMF staff calculations.

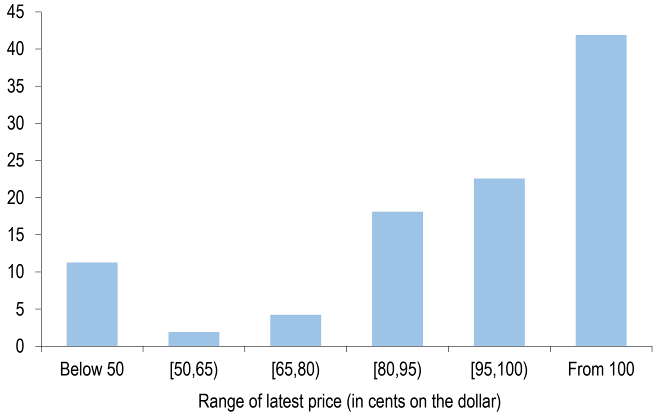
Note: For bond financing, the first part of 2021 covers January-July, and the second part covers August-December.

- As of 2021Q2, property developers also obtained nonbank financing via the trust channel (2.1 trillion RMB), onshore bonds (1.6 trillion RMB), and offshore bonds (1.8 trillion RMB). Total financing, including bank loans, would amount to nearly 18 trillion RMB.
- The ongoing asset management reform could limit funding via the trust channel. Property developers also face a non-negligible amount of maturing bonds.

## Analytical Feature: Financial Vulnerabilities Remain Elevated in the Property Sector (continued)

*In the offshore bond market, a number of property developers may not be able to raise new funds. Many bonds are currently traded with significant discounts.*

**33. Property Developers: Offshore Bond Price Distribution, As of August 24, 2021**
*(In percent of total issuance amount)*

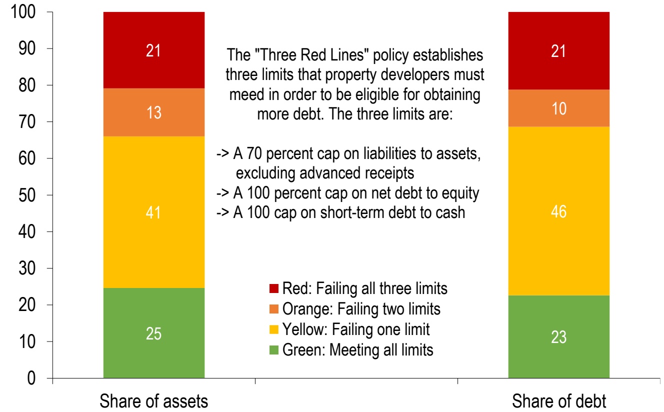



Sources: Bloomberg; and IMF staff calculations.

- In the offshore bond market, a number of property developers may not be able to raise new funds. Many bonds are currently traded with significant discounts.

*Only about a quarter of property developers, in terms of their assets or debt, pass all three red lines. They are able to increase their debt up to 15 percent.*

**34. Property Developers: Three Red Lines Policy**
*(In percent)*



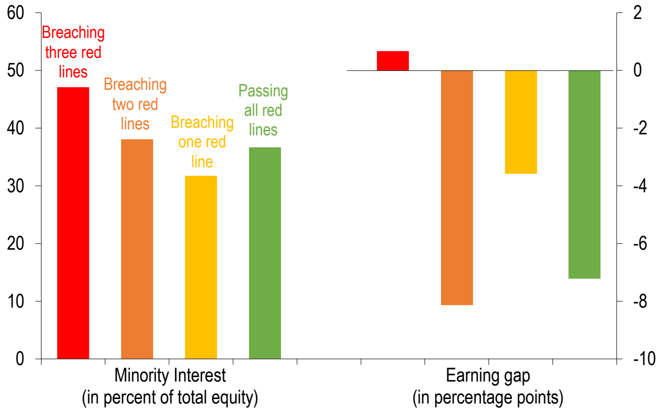

Sources: WIND; and IMF staff calculations.

Note: The analysis includes 315 property developers available from the WIND database.

- Meanwhile, property developers in the "red" category could face significant liquidity pressures given their inability to obtain additional funds.

*There is some evidence suggesting that property developers in the "red" category may have tried to hide some debt.*

**35. Property Developers: Minority Interest and Associated Earnings**



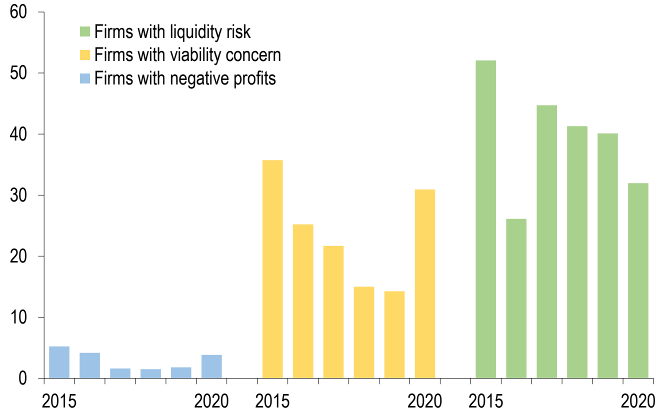

Sources: Capital IQ; and IMF staff estimates.

Note: The analysis includes 100 largest property developers available from the Capital IQ database. Earning gap is measured as the difference between net income attributed to minority interest (in percent of minority interest) and net income attributed to shareholders (in percent of shareholders' equity).

- These firms have a relatively high portion of minority interest, and the profit distribution attributed to minority interest is higher than to shareholders' equity.

*Many property developers have a viability concern -their earnings are not sufficient to cover net interest expense.*

**36. Property Developers: Risky Debt**
*(In percent of total debt)*




Sources: Capital IQ; and IMF staff estimates.

Note: The analysis includes 410 property developers available from the Capital IQ database. Firms with viability concern have EBIT less than net interest expense. Firms with liquidity risk have combined liquid assets and EBITDA less than combined short-term debt and net interest expense. The exercise considers "total" interest expense, using the maximum of interest expense per income statement, capitalized interest expense, and cash-based interest expense.

- Similarly, many property developers face liquidity risk, which could materialize if they become unable to refinance their maturing debt.