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CNY – Regulatory tightening, with new credit normal

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Key Points:

- **China's single-digit M2 growth would probably be the new normal**
- **The much smaller than expected new yuan loans in December should be temporary, while the focus should be on the allocation rationale: Fewer to mortgages, more to corporates**
- **2018 is a crucial year of assessment:**
  - **Would tighter financial regulations on shadow banking lending and qualify-focused direct financing be strictly implemented? If yes, slower overall growth for aggregate financing**
  - **Would financial deleveraging remain? If yes, steady growth for new yuan loans**

Last Friday (12 January 2018), the People's Bank of China (PBOC) released its money and credit figures for December and 2017, providing some good guidance this year.

M2 growth moderated to the lowest level on record

Financial regulatory tightening could weigh on M2 growth

China's M2 growth slowed to the lowest level on record of 8.2%YoY in December, below consensus expectations of 9.2%, after an unexpected slight acceleration in November (9.1%YoY > October 8.8%). The rather sharp slowdown in M2 growth for December could be in part explained by a seasonal decline in fiscal deposit (-CNY 1,233 billion vs. -CNY 1,155.9 billion in December 2016), in addition to **a decline of CNY912.9 billion in non-bank financial institution deposit**. The latter **caught our attention, as this might related to the drafted new rule in wealth management products that implicit guarantees would be prohibited**, jointly announced in mid-November by PBOC, China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission (CIRC) and State Foreign Exchange Administration (SAFE)[1].

M2: Goodbye to double-digit growth

Single-digit M2 growth would probably be the new normal

M2 grew at a single-digit pace for eight months in a row, far below the 12% official target for 2017. As part of the Chinese authorities' three-year campaign to curb the systemic financial risks, it is widely expected that the official M2 growth target this year would probably be below 10%, which would be the **new normal, echoing the Chinese authorities' commitment to financial deleveraging**.

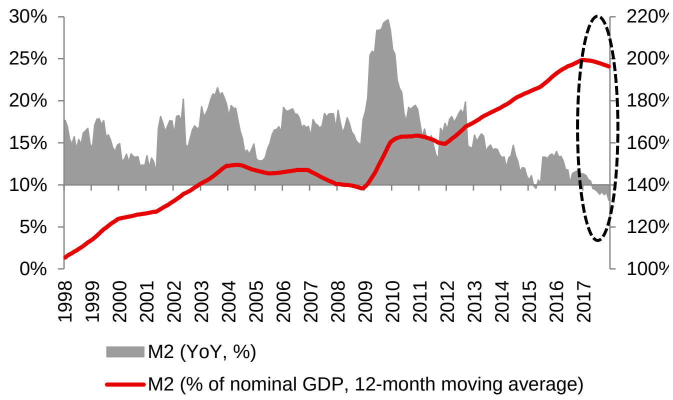
Credit fuelled economic growth in China might have gone

M2 in terms of nominal GDP, the downward sloping line (the red line in the left chart, Page 2), could suggest that **China's economic growth would no longer be mainly driven by credit, if such trend persists**. Yet, we have to bear in mind that **M2, a common broader measure of money supply, has become less representable in China**, as indicated by a declining proportion of the banks' total liability (as well as

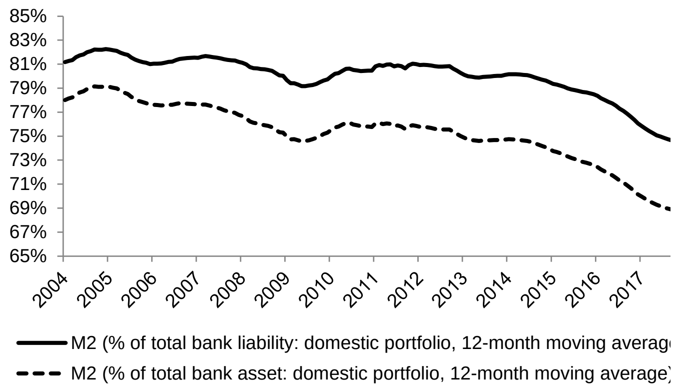
[1] Requesting Public Comments on the Guiding Opinions on Regulating Asset Management Business of Financial Institutions (Exposure Draft), dated 17 November 2017: http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3420451/index.html (simplified Chinese)

total asset) of domestic portfolio (the black line in the right chart). At the same time, corporate deleveraging in China has yet to be visible[2].

M2 GROWTH STAYS BELOW 10%



M2 BECOMES LESS REPRESENTABLE IN TERMS OF BANK ASSET AND LIABILITY



Source: CEIC, MUFG Bank

New yuan loans: Focus on allocation

The much smaller than expected new yuan loans should probably be temporary

New yuan loans halved to CNY 584.4 billion in December from CNY 1,120.0 billion the previous month. This was the smallest increase in 17 months, below consensus expectations of CNY 1,000 billion, probably due to some **temporary factors such as tighter year-end quota for bank loans and the macro prudential assessment (MPA) preparation for 1Q this year**.

The level of new yuan loans for December can hardly be taken as reference, but the allocation of new yuan loans last year would probably be a good guidance this year.

Allocation of new yuan loans this year: Fewer to mortgages, more to corporates

For the whole year of 2017, new yuan loans increased 7.0% over the previous year to CNY 13,530 billion (vs. 7.9% at CNY 12,650 billion in 2016). Household sector remained the main reason for an increase in new yuan loans last year, accounting for 52.7% of the total new yuan loans increase, but **medium and long term new yuan loans for households (i.e., mainly mortgages) represented only 39% of the total last year, down from 45% in 2016, against the backdrop of tighter home-purchase measures that would probably weigh on both home price gains and transactions**.

Meanwhile, new yuan loans to corporates (i.e., non-financial private and state corporations) represented 49.6% of the total increase in new yuan loans last year, with a notable stronger demand for medium and long-term financing (CNY 6,380.0 billion >> CNY 4,180 billion in 2016), while the total short-term and bill financing shrunk to only CNY 50 billion last year from CNY 1,622.9 billion in 2016.

Growth for new yuan loans will probably soften slightly this year

With the ongoing government-led financial deleveraging, growth for new yuan loans this year would probably come slightly below that for last year. The mortgage-fuelled household debts would probably continue to cool gradually, while the still strong credit demand from corporates would probably fill up the gap, possibly improving the overall credit effectiveness in the Chinese economy.

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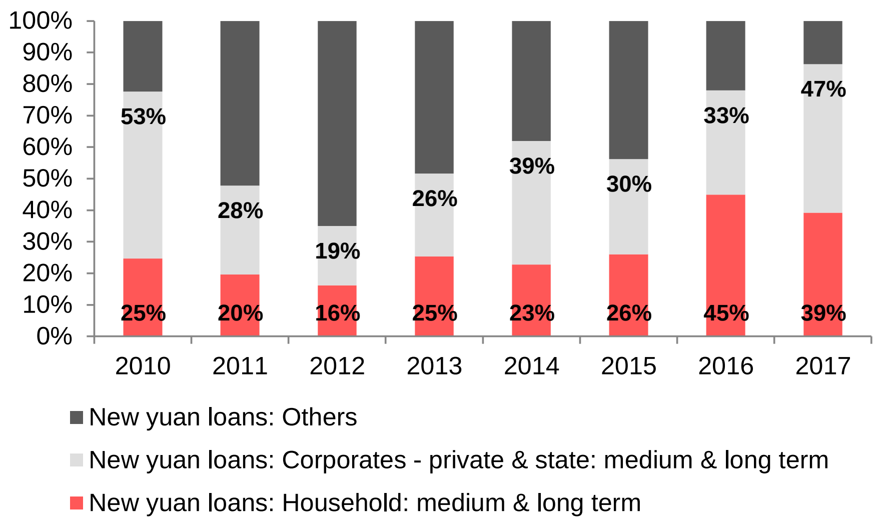
[2] Please read the theme note in the *January 2018 Foreign Exchange Outlook, "China Credit Risks Are Still Rising"* written by Cliff Tan for more details.

NEW YUAN LOANS: FEWER TO MORTGAGES, MORE TO CORPORATES



Source: CEIC, MUFG Bank

Aggregate Financing: Shadow banking lending remains our concerns

Aggregate financing's breakdown showed a broad-based slowing net increase, except for shadow banking lending

New increase in aggregate financing[3] in December of CNY 1,139.8 billion came below consensus expectations of CNY 1,500 billion and that of the previous month of CNY 1,619.6 billion (upwardly revised from CNY 1598.2 billion), mainly due to slower increase in new bank loans, in particular new yuan loans, while **there was a faster increase in new shadow banking lending** (CNY 356.8 billion > last CNY172.9 billion). It should be worth monitoring that some corporates shifted to shadow banking lending last month, but **on a positive note, CBRC introduced new measures to increase scrutiny on investments in commercial banks[4] and tighten regulation on the entrusted loans market[5]**, probably weighing on shadow banking lending growth this year.

Direct financing could be a game changer

Direct financing, if flourishes, would render some support for new increase in aggregate financing

In December, net increase in both corporate bond financing and non-financial equity issuance waned to CNY 62.06 billion and CNY 79.21 billion (< last CNY 71.61 billion and CNY 132.35 billion), respectively, amid higher bond yields and rather stringent IPO approvals. For the whole year of 2017, the representation of direct financing in aggregate financing declined to 14.3% from 15.2% in 2016, despite the introduction of Mainland-Hong Kong Bond Connect (Northbound trading) that commenced on 3 July 2017 and the positive announcement related to MSCI inclusion of China's A-shares on 20 June 2017.

With an expected slowdown in shadow banking lending amid tighter financial regulations and modest growth moderation for new yuan loans, direct financing (if

[3] China's aggregate financing compromises three key components: (1) bank loans (including both yuan loans and foreign currency loans), (2) shadow banking lending (including entrusted loans, trust loans and banker's acceptance bills) and (3) direct financing (including bonds and equities).

[4] CBRC's Requesting Public Comments on Risk Disclosure for Major Investments for Commercial Banks (5 January 2018) http://www.cbrc.gov.cn/chinese/home/docView/0A36349FFA75445BA5130852CC12BC8C.html (simplified Chinese)

[5] CBRC's Risk Management Systems and Procedures for Entrusted Loans for Commercial Banks (6 January 2018) http://www.cbrc.gov.cn/chinese/home/docView/D34DF8260C5E45CD871420EA413E3128.html (simplified Chinese)

flourishes), in the light of deepening financial market reforms , would probably render some support for new increase in aggregate financing. **CSRC is expected to accelerating IPO approvals, but is unlikely to tolerate substandard applicants**. About 29% of IPO applications were rejected during the January –October period last year, according to Reuters cited CSRC on 8 December 2018.

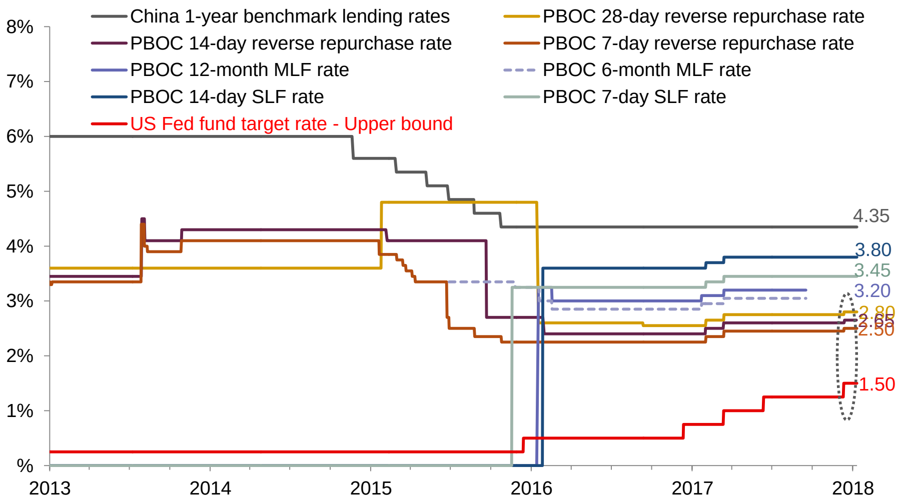
2018 is a crucial assessment year

The deleveraging in the financial sector is expected to continue, signaling a single-digit M2 growth this year and a modestly lower growth for new yuan loans. Demand for household mortgage loans amid cooling property markets would probably continue to slow, freeing up some room for medium to long term loans to corporates. **Tighter financial regulations on shadow banking lending and quality-focused direct financing, if strictly implemented, would probably mean a moderation for the overall growth for aggregate financing this year**, from an expansion of 12.0% in 2017 and 12.8% in 2016.

PBOC's prudent and neutral monetary stance this year means fairly tight liquidity, higher money market rates, and corporate financing costs,

With fairly tight credit supply and rather strong credit demand, corporate financing costs are expected to increase, even though we expect that **PBOC will maintain its "prudent and neutral" monetary stance this year, without making any adjustment to the benchmark interest rates**. Money market rates would nevertheless be guided higher, with small adjustment each time (like the hike of 5 basis points on 14 December 2017), but the timing would probably depend on the rate normalization schedule of the US Federal Reserve and onshore market liquidity.

HIGHER MONEY MARKET RATES, BUT SMALL ADJUSTMENT EACH TIME



Source: Bloomberg, MUFG Bank

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