Caixin Global Intelligence
China Weekly Macro Policy Analysis

Nov. 27 — Dec. 4

DISCOURSE

Shedding light on domestic politics and policymaking with concise analysis of the week's most important meetings, speeches and essays, so you know who is saying what, and why it matters.

Default Wave

The wave in bond defaults and other scary financial news, some reported by Caixin exclusively over the last few weeks, continues rocking the bond market and raising question over the government's determination to break the implicit guarantee. The message, so far, is a clear one: manage your own risks. Many hope it will inject some healthy skepticism in the market and help its long-term growth.

In case you missed some details of the default wave, here is a recap. The bond defaults include a wide range of SOEs, private or government-backed platforms and a variety of industries. Some major ones to watch are:

— central Henan proivince's Yongcheng Coal and Electricity Holding Group Co. Ltd. failed to repay an ultra-short-term 1 billion yuan bond that matured Nov. 10 despite receiving the highest possible rating from a domestic credit rating company in October;

— SOE heavyweight Tsinghua Unigroup failed to win creditor approval for a rollover of 1.3 billion yuan ($197 million) of bonds that came due Nov. 15;

— electronic display panel maker Tunghsu Optoelectronic Technology. Co. Ltd. couldn't come up with the cash to make the interest payments due Nov. 17 on a 2.2 billion yuan medium-term note and another 800 million yuan note;

— A wholly-owned logistics subsidiary of Jizhong Energy Group Co. Ltd., which is owned by the Hebei provincial government, failed to repay principal and interest of a 500 million yuan ($76 million) trust loan due Nov. 23 (it paid two days later, narrowly avoiding triggering cross-defaults clauses on other Jizhong Energy bonds);

— Brilliance Auto Group Holdings Co. Ltd., parent of German car giant BMW AG's main Chinese joint-venture partner, failed to repay 1 billion yuan ($152 million) in principal and 53 million yuan in interest on a bond due Oct. 23.

With these defaults, a number of other associated issues have also emerged, including downgradings of bond ratings, potential forced restructurings, and more.

There's been quite a bit of drama surrounding each of these developments, including failed attempts by the companies in question to get their debt rolled over, forced bankruptcy proceedings, creditor disagreements and more. We'll save you from the play-by-play, but suffice to say it has shaken the market.

The selloff of corporate bonds triggered by the defaults has caused at least 60 billion yuan ($9.15 billion) of losses for bond investors according to one brokerage estimate, as well as forcing other companies to cancel or delay bond issuance plans.

Four bond issuances worth 3.1 billion yuan ($471 million) were canceled in Henan, all by local SOEs after the Yongcheng coal bond default (Nov. 11 – Nov. 30). Nationwide, 100.4 billion yuan ($15.3

billion) of corporate bond issuances were either canceled or delayed in November, jumping from 34.3 billion yuan the previous month and 28.1 billion yuan in the same period last year. This brought the credit bond net financing in negative territory for two consecutive weeks, according to data compiled by Wind.

REGULATORS RESPOND

This has drawn a great deal of attention from investors and regulators alike. Traditionally, investors have viewed bonds issued by SOEs as less risky due to their perceived government backing. But Yi Gang, the governor of the PBOC, issued a series of surprisingly frank editorials, emphasizing that investors should manage their own risks, and it's time for the end of implicit guarantees. The central bank still moved last week to reassure markets, though, with a net injection of 200 billion yuan using its medium-term lending facility.

The Financial Stability and Development Committee, China's top financial regulatory body led by Vice Premier Liu He, also pledged "zero tolerance" for misconduct after it came to light that several of these defaults by high-profile state-owned enterprises may have been intentional attempts to dodge debt.

China's interbank market regulator further banned bond issuers from buying their own debt in an effort to keep defaults from destabilizing the financial system. The new National Association of Financial Market Institutional Investors regulation to clamp down on "structured issuance" bars issuers from subscribing to issuances of their own bonds in the interbank market or buying them indirectly through related parties or asset management products. Yongcheng's use of the technique is now at the center of a probe into the company as well as its underwriter Haitong Securities.

WHAT DOES IT MEAN FOR THE MARKET'S DEVELOPMENT?

While one debt investor told Caixin "this might be a historic credit crisis," some see a silver lining in the fact that the lack of bailouts for these companies may signal the beginning of the end of "implicit guarantees" for SOE debt. Despite the losses, this would be a positive development in the maturation of China's bond market.

"At least in the near-to-medium-term, the potential for China to suffer a systemic credit crisis appears quite small," according to economists at Nomura International (Hong Kong) Ltd., and while "an increase in SOE defaults is inevitable, and most likely we will see many more such defaults in coming years," some SOE defaults, if managed well, can improve the overall health of China's bond market.

But that doesn't mean all the problems are solved. It is true that lack of immediate bailouts and a zero-tolerance attitude towards fraud by the FSDC and other regulators are positive signals for the maturation of the bond market. But that's not the same as the end of the implicit guarantee, as economist Houze Song has noted. "That foundation is built on bank lending, which is about five times larger than bonds as a source of local financing…so long as the relationship between local governments and banks holds, a form of implicit guarantee will persist."

Financial regulation in the 14th FYP

Yi Huiman (CSRC), Guo Shuqing (CBRC), and Yi Gang (PBOC) all recently published their views on the state of financial regulation and what should be done in the next five-year plan, each writing a section of the guide to the Central Committee's proposal for the 14th five-year plan.

They're all worth reading if you have the time, but the most interesting piece was from Guo Shuqing. Guo focused in part on real estate, which he (unsurprisingly) characterized as "the biggest 'grey rhino' of China's financial risks at this stage," noting that the sector accounts for some 39% of bank loans in addition to a large proportion of bonds, equity, trust funds and more.

This is the fourth time in as many months that Guo has warned about real estate risks, including an August article in Qiushi preceding the “three red lines” policy, where he said the housing bubble was the biggest threat to financial security. He’s obviously right, but it is a bit late in the game for him to be making this point given how central the sector is to China’s economy. Regardless, better late than never.

Beyond real estate, he makes five main points:

— the ‘monetary economy’ must not deviate from the real economy
  - China’s financial sector was once very complex, but after more than three years of centralized regulation, regulators have been able to start bringing risk under control

— pursuit of profit is the normal state of business activities
  - Regulators’ role is to put limits on this - financial operations will run into trouble if they do not have a certain amount of capital. The core of the Basel Accord is to establish basic capital constraints on bank credit, and keep leverage ratio within a safe range

— benefits and risks are proportional
  - the promise of low-risk high-yield is fraud: financial regulation must always resolutely clamp down on such behavior

— China will continue to build an environment of rule of law and integrity
  - The core function of finance is credit intermediation
  - On the one hand, financial institutions should abide by professional ethics and provide “genuine” financial services. On the other hand, stakeholders such as shareholders and debtors should also respect their contracts; you can’t dodge debt for any reason

— Regulators should set boundaries on financial innovation
  - In the early days of internet finance, some online lending platforms operated illegally under the banner of “innovation,” resulting in huge financial and social risks

Guo also outlined what he sees as the key weaknesses in China’s financial system, including

— financial rule of law is still very imperfect; some basic laws and amendments still need to be planned

— some rules and regulations become very distorted in implementation

— financial supervision resources are obviously inadequate both in quantity and quality

— level of specialization and internationalization of financial supervision needs to be improved

As well as the key next steps to improve financial supervision, including

— improving supervision transparency and rule of law
  - taking laws and regulations as the criterion
  - raising the cost of breaking the law by a large margin

— ensuring financial regulation as a whole incorporates a macro-prudential viewpoint
  - based on microprudential principles and supported by behavioral regulation, realizing unity between the three

— strengthening supervision of financial infrastructure and management of intermediary institutions
  - e.g. fintech giants; regulators should adopt a special innovative regulatory approach to prevent risks and monopoly in promoting development, on the basis of inclusiveness and caution

DATA DIGEST

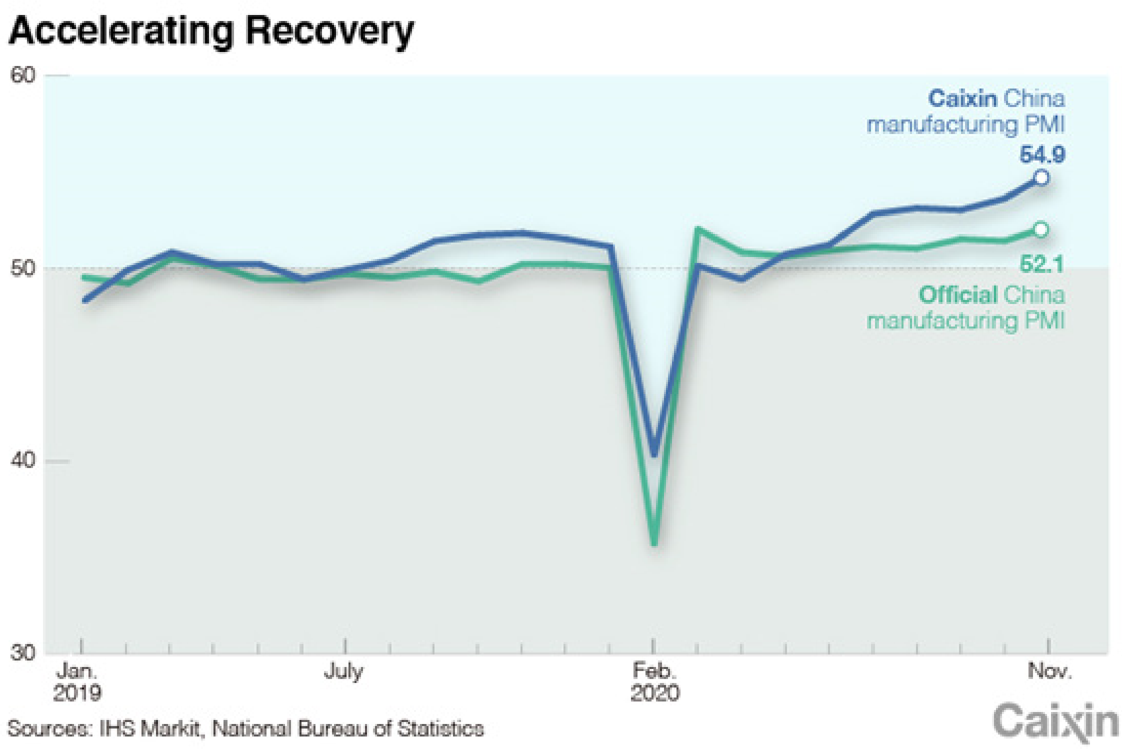
Illustrated insights into China's macroeconomy and what's happening on the ground in the financial sector.

Economic Recovery Picks Up Speed in November

The latest manufacturing and services PMI data showed that China's economic recovery accelerated last month as manufacturing and services activity saw their fastest growth in a decade.

MANUFACTURING

The Caixin China General Manufacturing PMI rose to 54.9 in November from 53.6 the previous month, marking the seventh consecutive month of expansion and hitting its highest since November 2010. The trend was in line with China's official manufacturing PMI, which jumped to 52.1 from 51.4 in October.

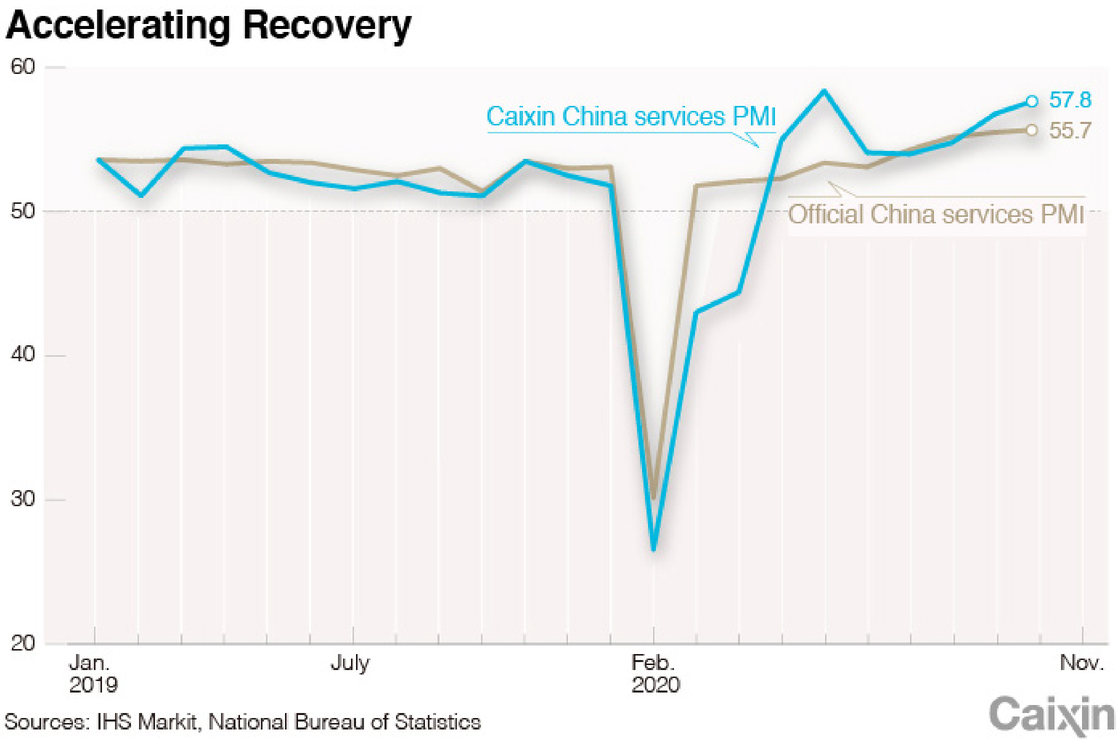


Both the supply and demand sides picked up steam, as the gauges for total new orders and output hit 10-year highs. The jump was due largely to an increase in domestic orders and raw material prices; new export orders also increased but the improvement was slightly weaker than for domestic demand, according to Wang Zhe, senior economist at Caixin Insight Group. Though the data was good for November, we believe that the resurgence of virus cases in key markets could hit overseas demand and might limit export orders in the coming months if there are lockdowns in the export destinations.

Manufacturing employment, which had dragged for several months, also rose at a faster pace in November. The employment subindex hit the highest level since May 2011. Meanwhile, purchasing quantities, stocks of purchases and finished goods all grew faster in November than the previous month.

SERVICES

The Caixin China General Services Business Activity Index, which gives an independent snapshot of operating conditions in the services sector, rose to 57.8 in November from 56.8 the previous month,hitting the second-highest level since April 2010, below only June's 58.4 reading. China's official services PMI, which was released on Monday, also rose to 55.7 (link in Chinese) in November from 55.5 the previous month, an over eight-year high.



Overseas demand returned to growth in November after shrinking for four months, with the measure for new export business reaching the highest point since April 2019. Wang Zhe noted that "Uncertainties caused by the pandemic did not slow growth in demand for services exports." Rising supply and sales in the services sector also prompted employers to add more staff, as the rate of job creation recorded the highest reading since October 2010.

Most analysts forecast China's economic recovery to remain on track through the fourth quarter and into next year: Nomura International forecasted year-on-year GDP growth of 5.7% for the fourth quarter, up from actual growth of 4.9% in the third quarter, and UBS Investment Bank AG expected China's GDP growth to rebound to 8.2% in 2021, led by exports and domestic consumption.

China is very likely to gradually wind down its monetary easing policies given the sustained economic recovery, even as a string of defaults by government backed SOEs sent tremors through the credit markets recently.

Liu Guoqiang, vice governor of the People's Bank of China, said last month that the timing of stimulus withdrawal should be sooner rather than later, and former finance minister Lou Jiwei said at the Caixin Summit that it was time to study an orderly exit of loose monetary policies.

POLICY

Digest of need-to-know policy developments with none of the noise.

RUN-UP TO END DECEMBER MEETINGS

There were very few concrete policy moves this week, as the government prepares for the the National People's Congress Standing Committee (NPCSC) meeting December 22-26, as well as the upcoming Central Economic Work Conference and Central Rural Work Conference, all of which will include major new measures associated with the 14th five-year plan.

NPCSC Chairman Li Zhanshu said last Friday that the committee would be reviewing 17 different laws and amendments, so expect much more news as the month goes on.

There have also been a number of personnel moves in recent weeks, the latest of which came on Tuesday with the appointment of Fujian province's new party secretary. (Yunnan, Jilin, Hunan and Guizhou also recently received new Party secretaries.)

Yin Li will be the new Fujian party secretary, leaving his former position as governor of Sichuan since 2015 after serving in a variety of public health roles, including on the executive committee of the WHO and a vice minister of the Ministry of Health.

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