Tackling root causes of financial risks

Government Work Report outlines plans to coordinate regulation and crack down on illegal borrowing

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The nation's top leadership has said the resolution and prevention of financial risks and the promotion of economic deleveraging will be key tasks this year, as many experts had predicted.

The announcement came during the two sessions, the gatherings of the National People's Congress (NPC) and the National Committee of the Chinese People's Political Consultative Conference (CPPCC), one of the country's biggest annual events.

With a slightly different emphasis from last year's task of building "strong firewalls" against specific risks in the financial sector, the country will tackle the problem by addressing the "root causes" with proper economic policies and necessary reforms instead of simply treating "the symptoms" in the financial markets.

The approach was underlined by the Government Work Report, delivered by Premier Li Keqiang on March 5, during the first session of the NPC, the nation's top legislative body.

"What China needs to do is tackle both the symptoms and root causes and take effective measures to defuse potential risks," Li said.

According to Yang Weimin, deputy head of the Office of the Central Leading Group on Financial and Economic Affairs, one way to address the root causes of financial risks would be to effectively control and manage the overall money supply and credit growth, which should be the most important job for those tasked with preventing financial risks.

For the first time in nine years, the Work Report did not set a specific target for M2, the broad measure of money supply. Instead, it stated that the administration will maintain a reasonable rate of M2 growth.

Zhou Xiaochuan, governor of the People's Bank of China (PBOC), the central bank, said M2 should not be the only indicator for understanding liquidity conditions, and many other factors, including prices and employment figures, should also be taken into consideration.

The toning down of the M2 target reflects the government's prudent stance on monetary policy and its cautious use of credit easing to stimulate growth. That is because credit easing could lead to asset bubble risks in the financial and property markets.

"We should not flood the market with excessive money printing," said Yang, a member of the CPPCC National Committee, the top political advisory body, when he spoke to reporters on the sidelines of the two sessions.

Curbing financial risks will also require tighter regulation and supervision of excessive borrowing by local governments, and a gradual cleanup of the bad loans associated with loss-making "zombie" State-owned enterprises, which have contributed to China's surging debt ratio in recent years.

Premier Li also vowed to crack down on illegal borrowing and guarantees by local governments. He stressed that the central government will not bail out local governments who default on loan repayments.

"All forms of borrowing and debt underwriting that violate the law and regulations are strictly prohibited. Provincial-level governments should assume overall responsibility for debts incurred by local governments within their jurisdiction," he said.

The government's reform of the financial regulatory system, aimed at improving coordination of different government agencies, will also be crucial to the prevention of financial risks.

In the Government Work Report, Li said the country will strengthen coordination of financial regulation and will also improve regulation of shadow banking, Internet finance and financial holding companies.

The reform of the country's financial regulatory system is part of a plan devised by the State Council, China's cabinet, to use structural reform to streamline and optimize State institutions.

The strategy was unveiled in February at the Third Plenary Session of the 19th Communist Party of China Central Committee.

"Strengthened coordination among regulators will help to eradicate the regulatory void and regulatory arbitrage, enabling full regulatory penetration and coverage. This will help to facilitate the smooth process of financial deleveraging," said Cheng Shi, chief economist at ICBC International.

"The improved regulations will also help to eliminate illegal borrowing by local governments and resolve the issue of their hidden debts."

China has already established the Financial Stability and Development Committee, which will serve as an interagency regulatory coordinator to ensure financial stability and fend off risks. The future role and policies of the committee were expected to be discussed and clarified during the two sessions.

Zhou said the PBOC will play a bigger role in the country's financial regulatory framework because the office of the newly established interagency committee is located within the central bank.

Iris Pang, a China economist at ING Bank, said the "financial super-regulator" will steer the reforms to guard against risks emanating from areas such as online financing platforms, personal loans and wealth management products.

"Financial deleveraging will be the key reform of 2018 because the government is determined to clean up shadow banking in the financial sector," she said.

Some economists have expressed concerns about tighter liquidity and a potential credit crunch in China as a result of strengthened regulation and tighter monetary policy.

"There could be some closures of small online financial platforms, possibly creating credit risks among banks and other nonbank financial institutions that have indirectly lent to those platforms through the interbank market and trust companies," Pang said.

"Overly tight liquidity could create tensions for banks and other financial institutions. But we see this risk as being quite low because the regulators manage liquidity on a daily basis."

Wang Tao, chief China economist at UBS Securities, said the PBOC will carefully manage liquidity conditions to ensure excessive tightening does not weigh on economic growth.

"With the ongoing tightening of financial regulations and supervision, the PBOC will need to carefully manage liquidity conditions to keep China's deleveraging implementation process smooth," Wang wrote in a research note.

Some economists interpreted the omission of specific targets for M2 and total social financing growth in the Government Work Report as an indication that the authorities intend to create more policy leeway and flexibility to address unexpected risks.

"The vague expression showed that the regulator does not want its policy to be labeled as either a tighter or a looser one. Instead, it hopes to use the expression to create more flexibility for its monetary policy," said Steven Zhang, chief economist at Morgan Stanley Huaxin Securities.