Quarterly Report on China's Financial Operation

(Q1 2018)

Executive Summary

1. Advanced economies continued to post upbeat economic performance in Q1 2018, resulting in their lowest-ever credit risks since the eruption of the global financial crisis. With a generally stable RMB exchange rate and increased foreign exchange reserves, China's external financial pressures were relatively stable in Q1 2018, but we need to closely follow the foreign exchange rate shocks caused by the U.S. dollar rebound.

2. In Q1 2018, deleveraging continued to make steady progress. While the aggregate real-economy leverage ratio slightly increased, government and financial sector leverage ratios decreased. The new regulations on asset management businesses further propelled the deleveraging process.

3. Growth of non-cash payment instruments in the payment and clearing system slowed significantly, and growth of business turnover far exceeded growth of trading value. Growth of personal bank settlement accounts continued to slow, resulting in a reduction in the overall growth of bank settlement accounts.

4. After the growth of bank size continued to slow near the end of 2017 and asset quality remained unchanged for three quarters, the NPL ratio and the balance of NPL both increased once again. Despite a slight increase in profit growth, average return on assets and average return on capital both increased compared with the previous year, which shows an increase in banking sector profitability under the tight regulatory environment.

5. Despite some volatility at the second-highest historic level, the credit spreads of credit products of various grades in China's bond market reduced compared with the beginning of the year. Some signs of recovery have emerged in the bond market: the credit spreads of various maturities changed slightly in the beginning of 2018, with long-term corporate bonds outperforming short-term and mid-term corporate bonds.

6. In Q1 2018, the rent capitalization rate of Tier-1 cities remained stable; the rent capitalization rate of Tier-2 cities ceased to increase; and the rent capitalization rate significantly reduced for Tier-3 cities, where real estate inventory greatly increased and additional risks were revealed.

I. China Financial Risk Index

In 2017, China's overall financial risk status and its change relative to 2016 can be depicted by the "NIFD China Financial Risk Index" in Figure 1. **This index consists of six components, including global macroeconomic risk, market and liquidity risk, credit risk, emerging economies' risk, China's financial condition index and China's external financial pressures.** Among them, the first four indicators depict global financial risk, and a higher positive value means greater risk, while a smaller negative value means smaller risk pressures. China's financial condition index consists of 13 indicators in four categories, including interest rate, exchange rate, stock market and social financing. These indicators reflect China's overall financial status, and a higher positive value denotes greater pressures on China's financial system, and vice versa. China's financial external pressure index reflects relative changes in the financial conditions, foreign exchange market and capital flow of China and advanced economies. As can be learned from Figure 1, **compared with 2016, China's financial risks in 2017 were manifested in tightening financial conditions (Figure 2) with slight improvement in other conditions.**

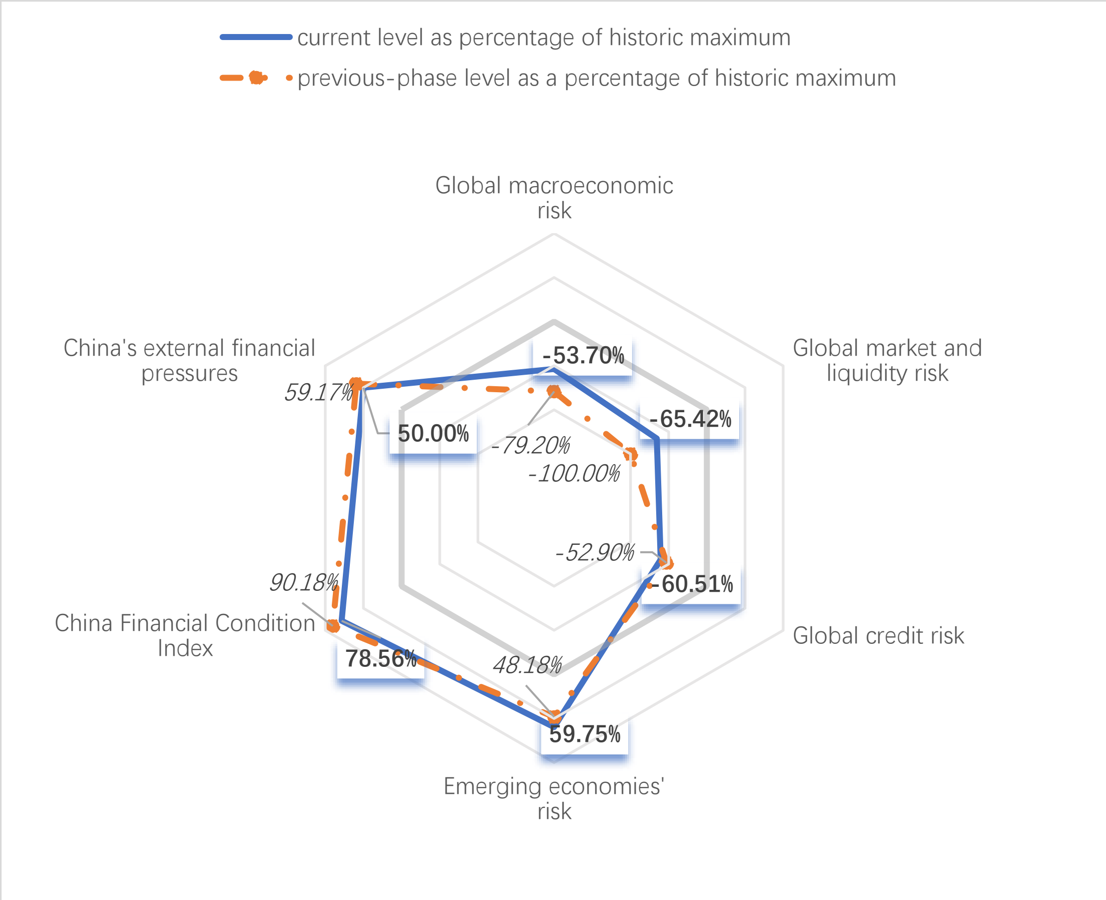

Figure 1 NIFD China Financial Risk Index: Q1 2018 in comparison with the previous quarter

Financial environments for advanced economies: In Q1 2018, the macroeconomic environment remained positive for major advanced economies. If the recovery is robust, the European Central Bank is expected to withdraw from quantitative easing by the end of 2018. Japan's monetary policy remains in a crisis without any sign of a turnaround. However, the Federal Reserve's monetary policy still has the most decisive influence on market liquidity. If the cumulative effect of liquidity tightening or austerity policy exceeds expectation, the current extremely easy liquidity conditions are likely to reverse, which is a cause for concern. Emerging economies are generally stable, but financial and fiscal pressures keep increasing due to economic structural imbalance. As discussed in the Q3 and Q4 2017 Reports, the market needs to follow U.S. corporate profit sustainability and a possible reversal in financial market liquidity - once materialized, it is likely to end the bullish U.S. market that lasted for over eight years, triggering another round of turbulence in global financial markets and the real economy. In Q1 2018, the U.S. stock market rerating triggered wild volatility in the stock markets of other advanced economies. Despite the impact on market and liquidity risks, there was no significant change in the easiness of market liquidity. **In the event of a reversal in the easy financial environment, re-evaluation pressures will swiftly emerge for financial assets in advanced economies.**

China's economic restructuring and financial regulation led to an increase in its **financial condition index** since Q4 2016. **This index remained in the pressure range in Q1 2018, and the overall pressures on the financial system were still significant.**

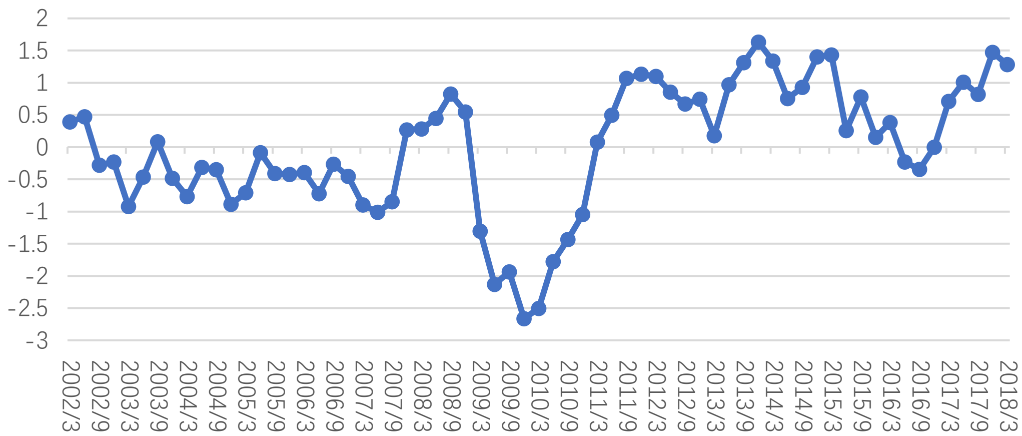

Figure 2 China's Financial Condition Index: China's Financial System Pressures Mounted under the Effects of Economic Restructuring and Financial Regulation

In the context of tight capital flow management, USD depreciation and reserve assets appreciation, China's foreign exchange reserves started to register positive growth since February 2017. In 2017, USD depreciation caused RMB's passive appreciation. Due to a stable RMB exchange rate and increased foreign exchange reserves, China's financial external pressure index was relatively stable in 2017, but external financial pressures were still determined by the relative change in real sector output and financial conditions of China and advanced economies. **We need to follow whether the USD index is taking an uptrend that may trigger changes in global capital flow and impact the exchange rates of other currencies.**

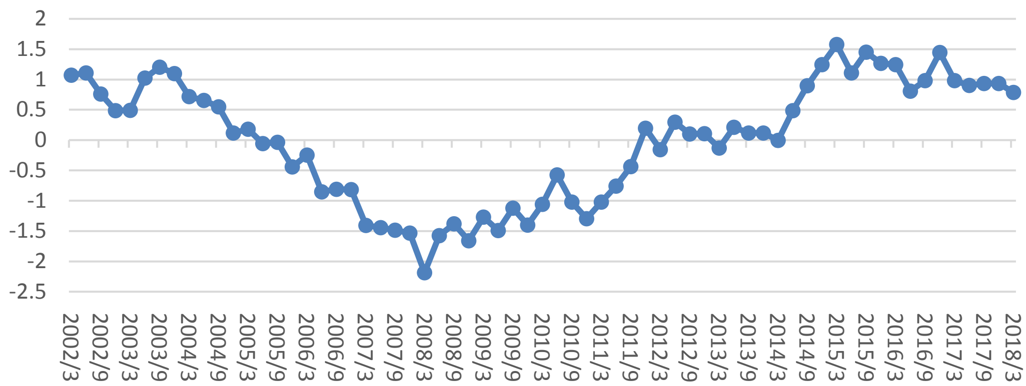

Figure 3 China's Financial External Pressure Index: External Pressures Eased but Shocks from USD Uptrend Require Attention

II. Leverage Ratio

In 2017, China's structural deleveraging made real progress. In Q1 2018, deleveraging continued to make steady progress.

Steadiness of progress was manifested in a small yet continual increase of real-economy leverage ratio. In Q1 2018, China's real-economy leverage ratio (encompassing the household sector, non-financial enterprises and the government sector) increased to 243.7%, up 1.6 percentage points from 242.1% at the end of 2017, which was still in a steady range. The leverage ratios of the household sector and non-financial enterprises both increased: compared with the end of 2017, household sector leverage ratio increased by 1.0 percentage point, and the leverage ratio of non-financial enterprises rose by 1.2 percentage points. Government sector leverage ratio reduced from 36.2% to 35.5%, down 0.6 percentage points (see Figure 4).

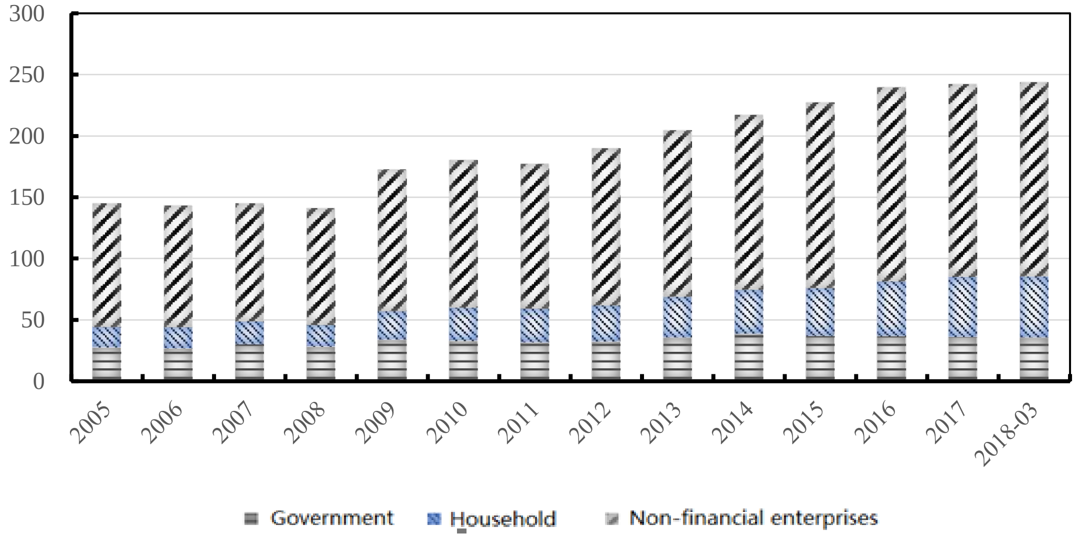

Figure 4 Real-Economy Leverage Ratio and Distribution (%)

Source: PBoC, NBS, the Ministry of Finance, Wind; CNBC.

Progress is reflected in the achievements of structural deleveraging and the reduction of government and financial sector leverage ratios. Government sector leverage ratio reduced to 35.5%, down 0.6 percentage points from 36.2% (see Figure 4). Financial sector leverage ratio continued to fall from both the asset and liability sides. Measured from the asset side, financial sector leverage ratio dropped to 66.8%, down from 69.7% in 2017. Measured from the liability side, it reduced from 62.9% to 61.7%. The reduction measured from the asset side was more significant, but the gap between asset side and liability side measurements further narrowed (see Figure 5).

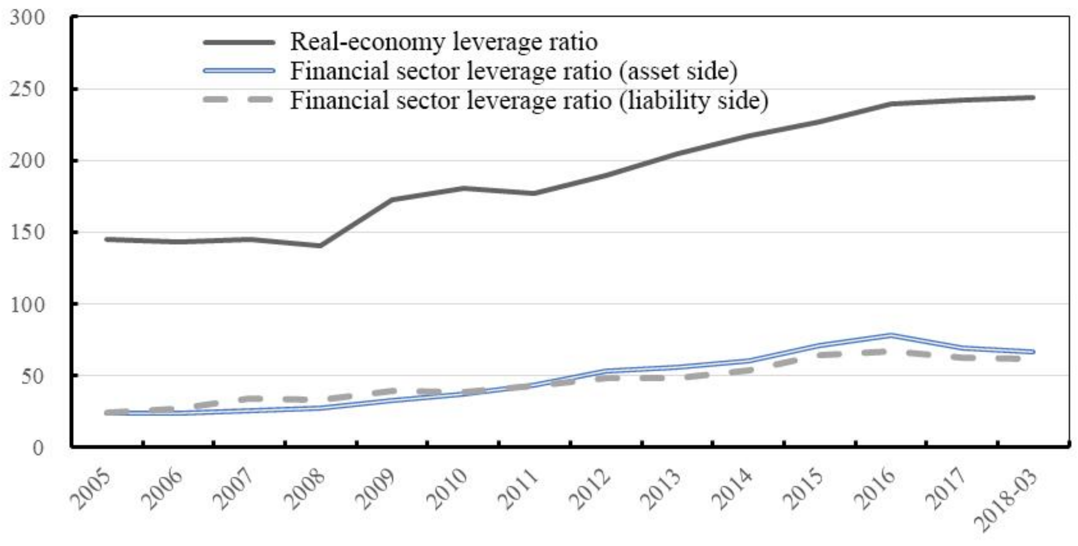

Figure 5 Real-Economy Leverage Ratio and Financial Sector Leverage Ratio (%)

Source: PBoC, NBS, the Ministry of Finance, Wind; CNBC.

III. Payment and Clearing

China's **payment and clearing** system's data (Figure 6) largely reflects the status of China's financial and real-economy operations, as well as changes in the financial condition index. Overall, **growth of transactions in the payment and clearing system slowed significantly compared with previous years, particularly for non-cash payment instruments**. In Q1 2018, there were a total of 45.585 billion non-cash payment transactions processed nationwide, involving a value of 930.60 trillion yuan, up 36.60% and 0.21% YoY respectively. Turnover growth continued to outpace growth of trading value. For payment instruments: the business volume of traditional payment business kept on the decline; bank card issuance continued increasing; the business volume of other clearing services such as credit transfer decreased; and electronic payment and especially mobile payment service maintained fairly rapid growth.

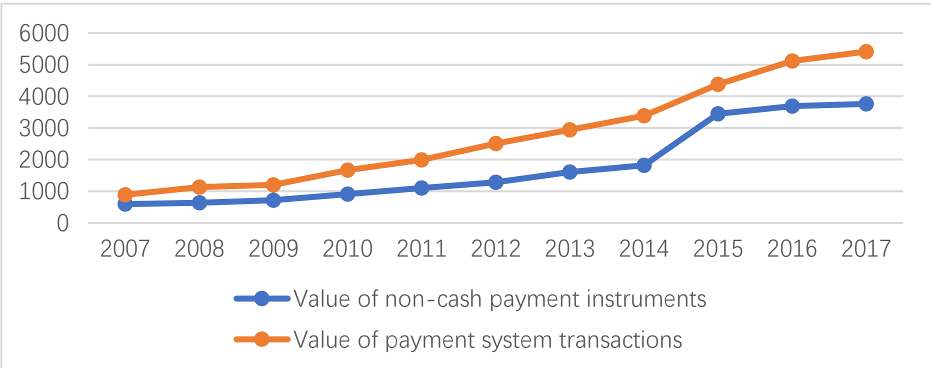

Figure 6 Growth in the Trading Value of China's Payment and Clearing System

Settlement accounts: the growth of personal bank settlement accounts continued to slow, causing a reduction in the overall growth of bank settlement accounts. By the end of Q1 2018, there were a total of 9.403 billion RMB-denominated bank settlement accounts opened nationwide, up 1.94% QoQ, and the growth rate dropped by 0.81 percentage points over the previous quarter. They included 56.2263 million organizational bank settlement accounts, up 2.54% QoQ, and the growth rate rose by 0.15 percentage points over the previous quarter; 9.347 billion personal bank settlement accounts, up 178 million compared with the end of the previous quarter, or 1.94% QoQ, and the growth rate dropped by 0.82 percentage points compared with the previous quarter.

IV. Banking Sector

In Q1 2018, China's banking sector operation was generally stable. As regulators launched an all-out campaign to prevent risks, deepen deleveraging and address market disorders, the growth of bank size slowed to 7.4% compared with the end of 2017, and the growth rate of joint-stock commercial banks fell to 3%, the lowest in recent years. Asset quality remained stable. NPL ratio – which had remained unchanged for three quarters - slightly increased to 1.75%. Simultaneous increases in NPL ratio and NPL balance are a cause for concern. By the types of institutions, the NPL ratios of large state-owned commercial banks and join-stock banks continued to decrease albeit slightly, down 1.5% and 1.7% respectively at the end of Q1 2018. However, the NPL ratios increased for both city commercial banks and rural commercial banks, reaching 1.53% and 3.26% respectively, which still present significant credit risk pressures.

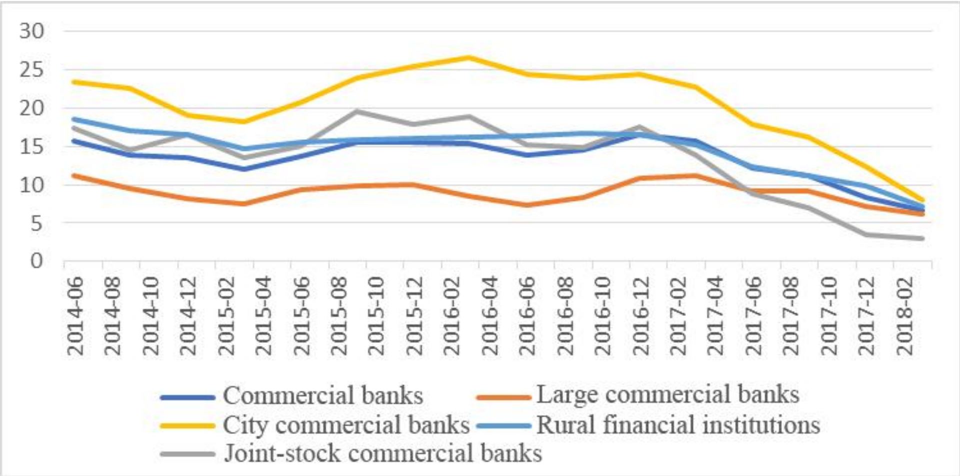

Figure 7 Asset Growth of Commercial Banks

Banking sector profit growth slightly increased, and average return on assets and average return on capital both increased over the previous year. This implies that despite the tight regulatory environment, banking sector profitability still increased. As for the contributing factors, falling NPL pressures reduced the provisioning cost expenditures of banks, and contributed the most to bank profitability.

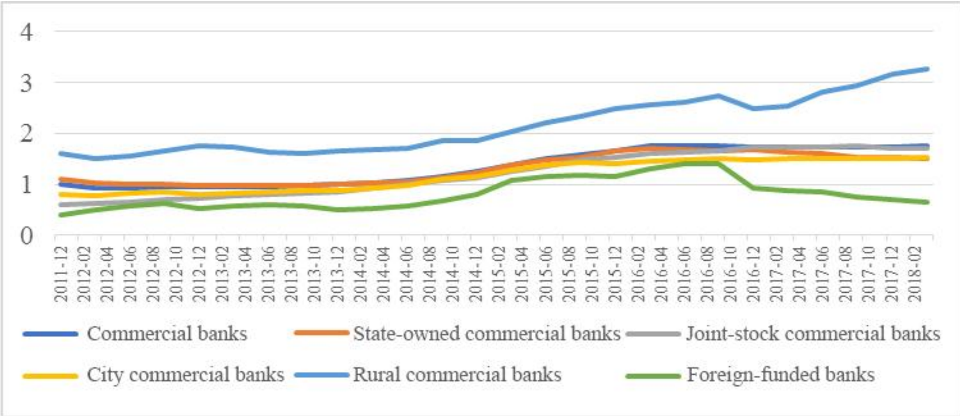

Figure 8 Change in Banking Sector NPL Ratio (%)

Source: CBRC, CIRC.

After the release of the new regulations on asset management, the issue of shadow banks remains the biggest challenge facing China's banking sector in 2018. Remodeling interbank and wealth management businesses will create shocks to banks' existing development model in the short run, and induce change in bank size, profit growth and income structure. Blocking off-balance-sheet financing will force banks to return to on-balance-sheet financing, causing significant capital consumption for the banks. On the other hand, capital chain ruptures of some financing entities may give rise to a new round of risk exposure, which warrants our attention.

V. Bond Market

Since the end of 2017, China's bond market yield curve has been generally on the decline. In terms of maturity structure, short-term interest rate declined at a faster pace than long-term interest rate. The shape of the curve changed from flat to steep. Despite some volatility at the second-highest historic level, the credit spreads of credit products of various grades reduced compared with the beginning of the year. The bond market showed some signs of recovery, and the credit spreads of various maturities changed slightly over early 2018, with long-term corporate bonds outperforming short-term and mid-term corporate bonds. Industry yield spreads kept widening, and risks in the real estate market should continue to be followed.

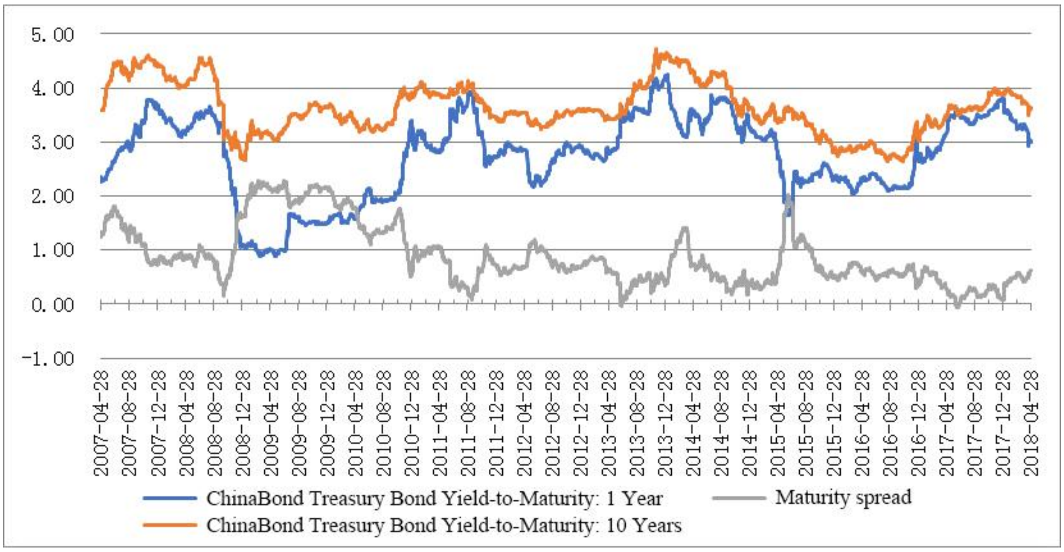

Figure 9 Change in Bond Interest Rate and Maturity Structure

The reason for the change was that weak fundamentals created downward pressures on interest rates. In 2018, China's monetary policy shifted from tight to neutral. Supply pressures of interest rate bonds are within control, and allocation demand increased. Despite some volatility at the second-highest historic level since 2018, the credit spreads of credit products of various grades have reduced compared with the beginning of the year. The bond market showed some signs of recovery: the credit spreads of various maturities changed slightly over early 2018, with long-term corporate bonds outperforming short-term and mid-term corporate bonds.

VI. Real Estate Market

The Chinese government has adopted a differentiated approach for housing market regulation for various cities. Under this approach, significant progress has been made in curbing housing price bubbles in Tier-1 cities. NBS statistics indicate that in Q1 2018, new house and second-hand house prices increased by -0.4% and 0.3% on a cumulative basis in Tier-1 cities. Except for a significant increase in the rent capitalization rate for Shenzhen, the rent capitalization rate remained generally stable for other Tier-1 cities. For Tier-2 cities, the rent capitalization rate ceased to increase and remained stable. For some cities, it even reduced, but whether a turning point has arrived still requires observation. The reason is that some Tier-2 cities competitively introduced policies to attract talents, which will boost housing price and rents. In Q1 2018, the rent capitalization rate significantly reduced for Tier-3 cities, where real estate inventory increased and additional risks were revealed. Our suggestion is that Tier-3 cities should strike a balance between long-term and short-term objectives in formulating real estate policies, and phase out the current policy that aims to reduce real estate inventory. At the very least, Tier-3 cities should no longer offer monetary incentives to resettled households in their urban renewal policy. Single-minded pursuit of short-term interests is like "quenching thirst with poison".

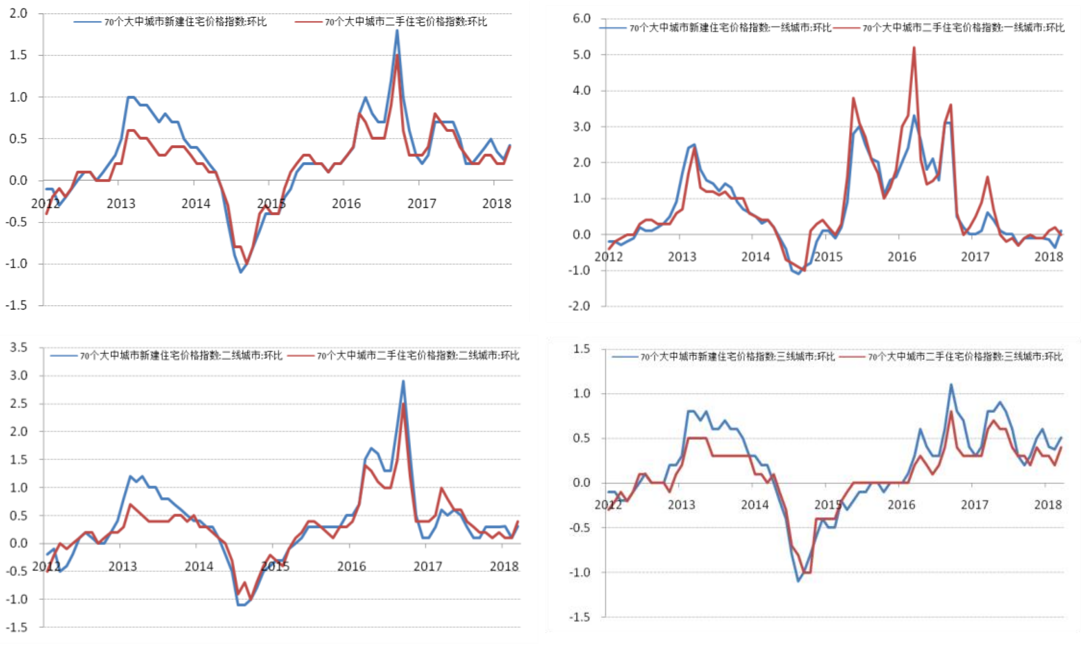

Figure 10 Housing Price in 70 Chinese Cities (QoQ)