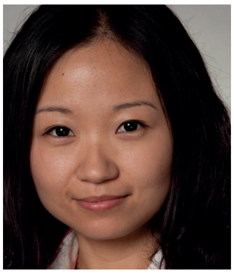

Deepening financial reforms in China

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On 4th March 2014 a major Chinese solar energy company, Chaori, shocked the financial market. Its announcement that it was unable to pay the interest of 90 million RMB associated with its corporate bonds due in full the following day, made it the country's first default in the domestic bond market since 1997. The government did not step in to bail out the failing company, sending a clear signal that China's financial reform will start to remove the long-standing issues of soft-budget constraints, be it for state-owned or private firms.

Following the news, the copper price suffered an unexpected drop, pushing its stock level higher, and signalling that economic activities may be weakened as a result. Due to its strategic importance in the national economy, copper has been used by many investors as collateral for bank loans. However, the weakening of the country's property market and RMB in recent months implies that any such financing deals will become significantly less profitable.

With the government's efforts to tighten bank loans and to implement hard budget constraints, investors should be prepared for more challenges. If they are unable to secure loans, they may need to sell off their metal stocks. This will inevitably lead to more price volatilities and a downward pressure on profit margins in the metal trading industry.

However, given the small size of the company and the relatively stable market environment, Chaori's interest payment default is unlikely to trigger any large market contagion effect in the short term. Some economists may even argue that perhaps Chaori has been used by the government to test the potential impact of its deepening reform efforts to reduce overcapacity in certain industries and to allow the financial market to play a more important role in improving production efficiency and industrial upgrading. As stated by Premier Li Keqiang after the incident, future defaults might be unavoidable as China's economy comes to a turning point and the government is no longer willing to step in to support failing companies.

2nd annual conference of the 12th National People's Congress (NPC)

In April 2014, another small building material company, Xuzhou Zhongsen Tonghao New Board Co, failed to pay interest on 180 million RMB of bonds, making it the second default on domestic bonds in a matter of only two months. The default by the company was also the first in China's high-yield bond market, which was launched in June 2012 in an effort to alleviate the financing difficulties of small and medium-sized private firms. The reaction of the market was muted and the Shanghai Composite Index was even up by 0.7% on the day. Nevertheless, investors should learn from this incident that taking high risks will be their own responsibility and the expectation of any state bailout may lead to an unexpected closure.

Conversely, to improve access to the financial market, in late February 2014 the Central Bank revealed details of trans-border RMB regulations in the newly-established Shanghai Free Trade Zone (FTZ). Companies set up in the FTZ are permitted to borrow offshore RMB without the restraints which prevailed in the past. For example, the Bank of Communications Financial Leasing (BCFL) has managed to obtain a 700 million RMB loan from Bank of Communications Singapore at an interest rate of less than 4%; significantly lower than the mainland lending rate which stood at over 6% at the time. As a result, the borrowing costs of companies in the FTZ will be reduced, allowing them to enjoy a much lighter financial burden. On the other hand, control measures related to money trafficking and the financing of terrorism have also been carefully drafted, showing the government's cautious attitude towards financial liberalization. All these policies are believed to be effective in preventing currency and interest arbitrage while assisting the globalization of RMB. The FTZ has been created as an experiment to assist the country's ambitious reform programme which may be rolled out to the rest of the country in the foreseeable future.

During the 2nd annual conference of the 12th National People's Congress (NPC) in March 2014, two new important financial and monetary reforms were announced by the central government.

After the removal of the floor on the bank lending rate in July 2013, the central government further removed the ceilings on smaller foreign currency deposits in the Shanghai Free Trade Zone (FTZ). In addition, since last October, China has launched a prime interest rate for commercial bank loans. Instead of relying on the benchmark rate as a guideline for lending, the new prime rate is based on the weighted average rate of the nine biggest domestic commercial banks' loans to their best corporate customers.

Although this move will not fully eliminate government intervention, it has given key Chinese lenders more say in the determination of lending rates. All these new policies have been used to test market reactions so as to set up a solid foundation for full-scale interest rate liberalisation in the country. It is widely believed that as early as next year, China will scrap the ceiling on bank deposit rates to realise full interest rate marketization.

The other reform is of the country's controversial exchange rate regime. Since 17th March 2014 the daily fluctuation range of RMB foreign exchange rate has been allowed to double from 1% to 2%. The last such relinquishing of the tightly controlled exchange rate band was in April 2012, when the PBOC doubled its daily trading band from 0.5% to 1%. This is a major step in further reforming the foreign exchange regime and making the Yuan more competitive as a trading instrument on the world stage. Market participants have long anticipated a constant one-way appreciation of the currency. The new policy shifts market expectation by allowing a two-way wider band. The increased flexibility will improve market efficiency and increase the decisive role played by the market in resource allocation. While on the other hand, companies in China - facing greater volatility in the Yuan's exchange rate - will have to learn how to manage their currency risks effectively.

Zhou Xiaochuan, governor of China's Central Bank, has made it clear that financial sector reform in China may be faster and deeper than generally expected. An official report at the recent NPC revealed a series of key proposals for the deepening of financial reform, including the introduction of a bank deposit insurance system, a plan to allow the private sector to set up small and medium-sized banks and other financial institutions, and a move to allow local governments to issue bonds.

Along with the further opening up of China's financial system, it is necessary to reassure bank depositors that their savings are safe. At the moment, only deposits with the 'Big Four' banks are implicitly backed up by the central government, leaving smaller banks less attractive to depositors. The introduction of the insurance system has offered a safety net, giving the banks more power in interest rate setting, while on the other hand, sending a strong signal to the market that banks could fail. This could in turn stimulate market competition, pushing the banks to become stronger and more resilient to external volatilities.

Prime Minister Li Keqiang

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Additionally, to ease the restrictions in the banking sector, ten private companies including Alibaba and Tencent were, since March 2014, allowed to set up private banks. As with other banks they must comply with the same set of banking regulations, but their main focus is on serving small and micro businesses. Currently, private investment only accounts for about 11-12% of the total assets of the Chinese banking industry. This move will inevitably loosen the government's control over the sector, allowing the market to play a bigger role in resource allocation.

Finally, to activate China's capital markets and to ease the financing difficulties of local governments, the National Development and Reform Commission (NDRC) has given the green light to local government bond sales in 2014. Currently, local governments mainly rely on land sales and Special Purpose Investment Vehicles (SPIVs), set up by local authorities such as Trust and Investment Companies (TICs), to meet their spending needs. Problems of revenue shortage at the local level have become even more serious, in particular after the world financial crisis.

According to the latest audit, by 2013, local government debts were about RMB 17.7 trillion ($2.9 billion), an increase of 70% from three years previously. Although the aggregate amount remains low compared with other developed nations, its speed of growth is worrisome. It is widely expected that the allowance of direct bond sales at the local level will phase out the opaque financing vehicles used by local governments and make the embedded risks more transparent. Over the long term, the establishment of a thriving municipal bond market would be the only solution for China to diversify the risks to a wider pool of potential investors.

Although it is currently hard to project the precise timeline for the full-scale implementation of these reforms, it is clear that the government is determined to increase market competition, to reduce the monopoly power of the state sector, and to restrain government intervention in the financial market.

China's new Prime Minister, Li Keqiang, considers market reform to be a dividend to sustain the country's economic growth and prosperity. The deepening reform methods to be implemented in the financial sector will enforce this message. ■