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TAIWAN ACADEMY OF BANKING AND FINANCE

The Impact of Changes in China's Economic and Financial Situation on Taiwanese Banking Industry (and Countermeasures)

Mandated by: The Bankers Association of the Republic of China

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Abstract

China currently faces problems including shadow banking, a real estate bubble, a highly leveraged state sector, local debt, illegal fundraising, online financing, irregular wealth management products, and corporate bond defaults. Any misstep could trigger systemic risks. Based on this, in early 2018, the Financial Stability and Development Commission established by the China Banking Regulatory Commission (CBRC) in November 2017 and the People's Bank of China (PBOC) established a bottom line of comprehensive prevention of system risks, which also highlights the importance of risk prevention policies to China.

In light of the close cross-strait economic and trading relationships, changes in China economic and financial situation can greatly impact Taiwan's economy. This study will research and analyze China's overall economy and finances. Due to policy continuity, follow-up developments of major past policies will continue to be tracked. Furthermore, the impact on cross-strait economic, trade, and financial exchanges will be self-evident in case China indeed undergoes drastic changes. This study also researches major non-recurring issues and events in order to clarify possible risks and losses for Taiwanese banks. Finally, resulting risk assessments and countermeasures are put forth for regulators to consider.

Background and Purpose of this Study

China's recent economic transformation, as well as the trade war with the US externally, has greatly impacted its economy and finances. Although Taiwanese investment in the mainland has contracted for three years, changes in China's investment environment reduced willingness to invest, and overseas investment has shifted from China to other locations, the large investments previously made cannot be reversed in the blink of an eye. Therefore, this study will research and analyze China's overall economic and financial situation.

China's Overall Economy

According to figures from the National Bureau of Statistics, nominal GDP in 2018 was RMB 90.03 trillion yuan, and real GDP grew at 6.6%, although declining on a quarterly basis, mainly due to the impact of the trade war on exports, contraction in internal demand, an accelerated decline in infrastructure investment, and the impact of deleveraging on corporate operations. By industry, the primary industry (agriculture) had RMB 6.473 billion in value added (3.5% growth), the value added of the secondary industry (manufacturing) was RMB 36.600 (growth of 5.8%), and the tertiary industry (services) had RMB 46.957 billion, growth of 7.4%.

The latest Caixin PMI issued in December 2018 was 49.7%, the lowest level since June 2017, and below the 50% neutral mark, indicating increased downward pressure on the economy. The official PMI issued by the Bureau of Statistics was 49.4%; the manufacturing boom has weakened, in line with the Caixin PMI, indicating that the manufacturing industry has been affected by the trade war, slowing growth.

The December 2018 unemployment rate in surveyed towns and cities was 4.9%, but outsiders are skeptical about official unemployment data. Based on job advertisements, the job market has entered a danger zone. According to the latest data released by Liepin's Global Employment Development Center, corporate recruitment plans in 4Q 2018 trended down; the major Chinese recruitment platform 51job.com also withdrew

2.02 million ads within half a year. Moreover, central and local governments have issued strong employment policies – for instance, companies that implement youth trainee programs and do not lay off workers or reduce layoffs can be refunded 50% of the unemployment insurance premiums paid in the previous year. Such measures show that the job market situation is much worse than shown in the official employment data.

Major international financial institutions and think tanks are mostly pessimistic about China's economic growth in 2019 relative to 2018, and their predicted growth rates for the whole year fall in the range of 6%-6.5%.

Major Economic Policies and Events

After several rounds of negotiations between the US and China, there are no signs of a cease fire in the short term. The main reason for this is that the US is dissatisfied and impatient with its large trade deficit and domestic unemployment over many years, especially towards China. 17 years after its accession in late 2001, with American encouragement and assistance, it still has not opened up to foreign competition. It still uses technical standards, subsidies, certification procedures, and regulation, as non-tariff barriers to foreign trade and investment. The US further objects to joint venture and intellectual property transfer requirements, which it considers to be unfair advantages.

The Made in China 2025 strategy, started in 2015, and the earlier Belt & Road Initiative have both caused fears about China's geopolitical strength and influence. The US has formed an unusual internal consensus that China's rise not only forms a strategic challenge to the US, but also uses its goodwill against it. Even former Treasury Secretary Henry Paulson, who has long been friendly to China, warned on November 7, 2018 that Washington was forming a consensus that China was looking increasingly like an adversary. If the two sides could not resolve their differences, an "economic iron curtain" would be formed between them. He suggested that China be bolder in opening up its markets.

In order to reduce the impact of deleveraging on markets and business operations, in the second half of 2018, China began moving from deleveraging to stabilization. It eased financial supervision slightly, and in line with its fiscal and monetary policies, it introduced corporate tax cuts and RRR cuts to release liquidity, which is expected to protect the credit environment. Regulations were also relaxed for a period. In July 2018, the People's Bank of China (PBOC) announced implementation rules and supporting policies for the new asset management rules. Although the overall regulatory direction remains unchanged, regulations on projects that were too heavily affected during policy implementation were moderately adjusted to enhance banks' operations and stability expectations, alleviating market liquidity pressure.

On March 24, Yi Gang, Governor of the PBOC, stated at the 2019 China Development Form that the key research task that year was to accurately value the market and provide sufficient tools to effectively manage risks, and to encourage banks to attract foreign capital by the end of the year. He also re-emphasized the necessity of foreign financial opening, to fully implement national treatment plus negative list management for market entry, so that both Chinese and foreign institutions have equal opportunities to enter non-prohibited businesses in accordance with the law.

The Impact on Taiwanese Banks and Countermeasures

China's economic development is clearly facing a bottleneck, which is why it has proposed supply side structural reforms. This however occurred at the same time that the US started introducing tariffs, which increased the overall difficulty of growth. It has impacted exporters and manufacturers on a psychological level, thereby also affecting China's previous efforts at RMB and stock market stabilization. Illustrating the seriousness of the situation, the world "risk" appeared 24 times in the March 5 Government Work Report from the Central Economic Work Conference in late December 2018.

Taiwanese banks have been going west to set up branches in China for many years, but they have remained small, and Chinese regulators typically set standards based on size, making it difficult for them to compete with other foreign-funded or domestic banks. Now that China intends to open up its financial sector, foreign capital enjoys national treatment, which will intensify competition in the banking sector. Taiwanese banks must take advantage of their familiarity with Taiwanese businesses, excellent talent reserves, and rich experience operating credit cards to seize the opportunity to serve local Taiwanese or other consumer groups and companies, including Chinese ones. In particular, Chinese SMEs have faced longstanding problems with financing cost and availability. In Shanghai, Shenzhen, and Xiamen, Taiwan's main business areas, Taiwanese banks can provide comprehensive cross-border services, higher service standards, and better customer guidance. Taiwanese banks have many years of experience and expertise in consumer finance that can help promote inclusive finance. They can also take advantage of the saving habits of Chinese consumers to promote wealth management products.

The root of financial vulnerability is high debt load. As of the end of 2017, China's total debt (government + household + non-financial corporate) was about 249% of GDP. Although this ratio is comparable to those in Europe and the US, the speed of its growth is worth watching. In particular, debt in the non-financial corporate sector has been on the rise, increasing 65.9 percentage points over a decade. Therefore, effective precautions must be taken to prevent corporate debt risks from impacting financial stability. The *Opinions on Actively and Reliably Reducing Corporate Leverage* issued by the State Council on September 22, 2016 (GF [2016] No. 54) regarded corporate leverage reduction as a key task of supply-side structural reform to resolve potential debt risks. It Opinions required relevant departments to take seven comprehensive measures: to promote mergers and reorganizations, modernize the enterprise system to strengthen self-discipline, revitalize existing assets, optimize debt structure, carry out orderly market-oriented bank debt-to-equity swaps, legal bankruptcy, and equity financing. These measures are however a bitter pill to swallow, and have been largely unsuccessful.

Conclusions and Recommendations

1. Conclusions

The trade war has been heating up and expanding to other areas, and may cause economic and financial risk issues such as weak domestic demand, devaluation of the RMB, or capital outflows. Whether the future of China's economic and social development will be harmed remains to be seen. For a small and open economy like Taiwan, it marks an important turning point. Having originally oriented its industrial policy towards export processing, it is now considering whether its model of many years, taking orders in Taiwan, producing in China, and selling abroad and dividing their labor globally, can survive in the context of growing conflicts between the US and China, or whether it should take this opportunity to upgrade and transform its supply chains.

2. Recommendations

There is a close relationship of mutual support between banks and industry. China is not only an important export area for Taiwan, but also a destination for overseas factories. In the current political and economic environment, incentives for Taiwanese companies to move to China are gradually diminishing, while smaller Taiwanese businesses often face difficulties in the price and availability of financing. Given these issues, Taiwanese financial institutions, including banks and securities companies, should support production upgrade and innovation, while ensuring risk control.

As the US strengthens sanctions or bans on Chinese companies, based on KYC principles, banks should analyze which customers may be impacted, in order to maintain credit asset security, and which customers may be related to US blacklisted entities, in order to prevent the recurrence of technology theft. In particular, if the US launches a further offensive on Chinese technology supply chains, the impact may be even broader. Manufacturers associated with Lenovo, Huawei, and ZTE should be watched especially carefully. In addition to supply relationships, equity investments into Chinese entities should also be carefully considered. For example, the Tsinghua Unigroup jointly invested in ChipMOS’s subsidiary Shanghai Hongmao. SPIL also sold 30% of its Suzhou subsidiary to Tsinghua Unigroup, and Chipbond also sold equity in its subsidiary to them. Because the US bases its nationality criteria on control, Taiwanese companies may eventually be determined to be on the Chinese team and receive sanctions, which could affect banks’ changes to recover claims on these companies.

In addition, in 2019, the government also release the *Action Plan for Welcoming Overseas Taiwanese Businesses to Return to Invest in Taiwan*, which will be implemented from 2019-2021 (three years) and provide one-stop service based on business needs. The Ministry of Economic Affairs has created an Invest Taiwan office to integrate land, water, electricity, manpower, tax, and investment policy measures, in order to help Taiwanese businesses return and thereby help local industry. In order to attract even more investment, on June 20, 2019, the Executive Yuan passed the Three Investment Plans: *the Action Plan 2.0 for Welcoming Overseas Taiwanese Businesses to Return to Invest in Taiwan*, *Action Plan to Accelerate Business Investment in Taiwan*, and *Action Plan to Accelerate SME Investment*. Therefore, it is recommended that financial institutions pay close attention to developments in the trade war and Taiwanese supply chain adjustments in order to offer timely assistance while controlling risks.