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

Mandated by: The Bankers Association of the Republic of China

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Abstract

This study explores trends in China's economy and financial and business reforms from two respects. First is the impact of important policies like China's overall strategy and development, including the 2017 Government Work Report, a re-examination of structural supply-side reform, and seven major free-trade zones (FTZs), on Taiwanese banks. Second is the possible impact of major non-recurrent policies and events, mainly RMB devaluation risk, a housing bubble, state and private enterprise debt risk, strengthened regulatory measures, and Trump's tax reforms. These hidden dangers may morph into systemic risks, so China has taken official efforts to alleviate them since 2017, regarding this as national-level matter. For Taiwan's government, because cross-strait financial exchanges are increasing by day, risk evaluation and avoidance are becoming more important, therefore this study focuses on risk. Finally, this study clarifies possible risks for Taiwanese banks, and proposes relevant risk assessments and countermeasures for use the government to formulate financial policies, and for banks to form business plans.

Background and objectives

China has been working to manage systemic risks since 2017. Because cross-strait financial exchanges are increasing by day, understanding and avoidance of risks is becoming more important for Taiwan’s government.

The purpose of this study is to explore the possible impact of China’s economic situation, development trends, financial policies, and business reform on Taiwanese banks, for reference by the government and banks. Each of these items are discussed in terms of overall economic strategy and major non-recurrent policies, to clarify the possible risks faced by Taiwanese banks and propose risk assessment and mitigation strategies.

Overview of the Chinese economy

Economic stability is a key item in the Chinese government’s internal power consolidation struggle, so the 2017 economic growth target has been set at 6.5%. China’s overall economy has gradually improved in 2017. Growth has turned the corner, employment is stable, production indicators are strengthening, prices are stable, and the international balance of payments is improving.

In terms of policy, supply-side structural reform has deepened, with good economic and industrial benefits. The 13th Five-Year Plan has also entered a critical year towards the goal of “building a well-off society in an all-round way.” Hidden dangers however lurk, causing financial risks, and influencing internal financial stability. These risks may not be realized, but government and industry alike must absolutely pay attention to the possibility of a “grey rhino” event. When and if it occurs, the damage and scope will be no less than that of the subprime crisis in 2008. For Taiwan, located nearby, it will be difficult to distance itself.

Has the Chinese economy hit bottom? The answer, from many interviews with experts, is that it will not be difficult for China to maintain 6.5% growth this year. The key is whether or not the L-shaped inflection point has been reached. Many scholars in China think so.

China's overall economic strategy and development trends

This section examines China's overall economic strategy and development trends, including the 2017 Government Work Report, supply-side structural reforms, and the seven major free trade zones. The Government Work Report can be seen as China's national policy direction guide for the year, covering overall plans and objectives. "Supply-side structural reform" is the specific method. It is still a key point for 2017, and has achieved initial results. Monetary policy is maintaining "stable neutrality," and fiscal policy is becoming "more stable and active." The Report however deepens risk prevention, particularly regarding the real estate bubble and corporate leverage, which will remain important items for the future.

The establishment of the third wave of seven free trade zones (FTZs) links up the overland Silk Road in an attempt to open up new export markets for China to resolve its overcapacity and promote the development of inland areas, reducing their gap with the coastal areas. The seven FTZs are Liaoning, Zhejiang, Henan, Hubei, Sichuan, and Shaanxi Provinces and Chongqing Municipality. They have expanded the scale of their pilot zones, and emphasized differentiated development based on their own characteristics, and continued to decentralize and open up. This third batch of FTZs follows China's strategy of gradual development, gradually expanding the Northeast, Northern, Central, and Western gateways. It echoes the Belt and Road initiative, complementing the external components. In the future, the seven FTZs will allow for innovative measures and business models, with commensurate business opportunities.

Major non-recurring policies and events

This section observes policies and events such as RMB risk, the real estate market bubble, risk involving state-owned enterprise (SOE) debt, stronger regulations, and Trump's tax reforms, and their possible impact on Taiwanese banks.

A. RMB risk: In 2017, in order to stabilize foreign exchange reserves and the RMB exchange rate, China strictly controlled the outflow of funds. In addition to a series of control measure, the government also introduced a "counter-cyclical factor" in the RMB mid-price quotation model, which saw results in the second half of 2017. Foreign exchange reserves gradually stabilized, and the weakening of the USD due to the geopolitical influence of North Korea led to a sharp rise in the RMB, which made depreciation necessary.

B. Real estate bubble: Inventory reduction is one focus of supply side structural reform. The Party has been promoting various credit and tax preference policies in recent years, attempting to both reduce market inventory and bring down excessive prices. In addition, the price rises in different Chinese cities vary, and different cities have different restrictions on sale and purchase, in the hopes of avoiding a bubble.

C. State-owned and private enterprise debt: In the past, Chinese businesses grew through borrowing. When the economic situation reverses, however, less stable companies may default. 2017 had slightly fewer than the 80 corporate defaults in 2016. Notably, among the corporations which defaulted in 2017, most had previously already done so multiple times, indicating fundamental problems in these companies. A proper exit mechanism must be established.

D. Strengthened controls: Rapid commodity innovation in China, combined with a relatively backward regulatory system, have caused the business to be dominated by arbitrage, resulting in a large number of regulatory dead ends. In addition, financial institutions are oriented towards short-term gains, significantly weakening their support for the real economy (particularly small and medium-sized enterprises). The CRBC has issued a series of financial market policies, and policy is expected to continue strengthening.

E. Trump's tax policy: Tax cuts, aimed at economic growth and reducing the tax burden on the middle class, were an important campaign promise for Trump. The new tax bill not only stimulates his morale and that of his team, but will also impact the US midterm elections. The attraction of foreign capital to set up factories in the US in the future may affect international industry chains.

The impact on Taiwanese banks and possible countermeasures

1. The impact of China's overall strategy and development

China's supply-side reforms may have both positive and negative, and direct and indirect impacts on Taiwan's banking industry. 1. The integration of Taiwanese manufacturers into the "red supply chain"; 2. The risk of more non-performing loans and debt defaults from industrial restructuring; 3. The challenge of industrial structural transformation to the traditional mortgage financing model; 4. The impact of narrowing spreads on deposits; 5. The challenge of China's industrial upgrade and development to Taiwanese business and industry; and 6. Deeper informatization of services, increasing the diversity and complexity of financial services. Responses to these challenges include research on possible business opportunities in supply side reforms, future opportunities in capital expansion, strengthened risk management, increased investment on major risks, attention to local government policies to avoid potential landmines, and strengthened IT investment in response to the Fintech trend.

The impacts of the seven FTZs include: 1. Taiwanese businesses can also set up inland, closer to inland markets, in addition to the coastal cities. Lower capital costs mean they can take the opportunity to participate in the Silk Road; and 2. In 2017, the new FTZs will relax their barriers to foreign investment. Banks should understand and adapt to local conditions.

2. The impact of major non-recurring policies and events and possible countermeasures

The following analyses and response measures are proposed for major non-recurring policies and events.

First, the RMB exchange rate fluctuated greatly in 2017, with a V-shaped reversal, increasing the need for businesses to prevent exchange rate risks, increasing the profits of Taiwanese banks in China, and causing an expected loosening of capital controls. Responses include prudent avoidance of RMB exchange rate risks and continuing observation of capital control policies.

Second, real estate prices are forming a bubble. If prices collapse, the impact on the overall economy and financial markets could include possible local debt crises and related financial risks, affecting indirect finance and even investment demand, triggering systemic risk, and reducing consumer expenditures, affecting domestic demand. The impact on Taiwanese banks could include direct impact on their local credit customers, credit guarantees for other companies in China, or impact on trade credit for Chinese exporters. Banks should keep an eye on real estate issues and US interest rates and pay close attention to relevant policy and GDP trends.

Third, the impact of state and private corporate debt on Taiwanese banks is relatively indirect. Taiwanese banks are not deeply involved in corporate debt. The larger point is that some local companies have local government guarantees, and some Taiwanese banks have allowed for temporary credit or joint lending. Some cases in recent years have affected Taiwanese banks, so they need to be cautious about future participation. Banks should fully understand the latest developments of SOE debt for early response, pay close attention to China's overall economic development trends and official policies, and establish a credit information system for their clients and early warning risk mechanisms.

Fourth, while stronger regulation undoubtedly has positive effects in preventing corporate financial risks like bad debts and real estate bubbles, it also increases legal and regulatory compliance costs for Taiwanese banks. Taiwanese banks are expected to set up operations in China in the future or do cross-border business involving China, and they will face stricter regulations and higher costs. Although financial markets and the real economy are bound to be affected by the reform process, the results of the reform should be good in the long term. Responses include watching China's regulatory trends for early response and strengthening investment in talent and information technology to meet the needs of regulation. The hope of regulation is to return finance to its origin.

Fifth, Trump's tax reforms have influenced global investment trends, possibly causing supply chain movement, including for Taiwanese producers. The effects will include Taiwanese exports to China, the triangular trade of Taiwanese businesses, and Taiwan's taxation and foreign investment. Responses include watching follow-up developments in American policy and observing cross-strait industrial and business trends for early deployment. Banks should strengthen their compliance in response to the future needs of globalization.

Conclusions and Recommendations

1. Conclusions

Analysis of official documents and policies helps us understand the impact of changes in China's economic situation on the Taiwanese economy and financial institutions.

In terms of economy, the overall situation in mainland China has gradually stabilized in 2017. The international situation has gradually recovered, causing an increase in external demand, driving an increase in Chinese exports. Meanwhile, China's domestic supply-side reforms have already yielded initial results. The iron and steel industries have resolved their excess capacity problems. Some cities have adopted measures to limit housing purchases, and destocking has been effective. In terms of costs, more than 10 regions have implemented cost reduction measures, and a series of measures have been introduced to reduce corporate taxes and fees, remedying shortcomings including investments in agriculture, environment, and high-tech industries. Local governments have strengthened their hard infrastructure, but shortcomings remain in factor markets, social security, and property rights.

China's promotion of new urbanization and solutions to excessive real estate prices or inventory mainly involve planning and establishment of urban agglomerations, and the construction of characteristic townships. China has begun to reverse the isolation of urban developments and gradually form a concept of new urbanization, while ensuring a high growth rate. Urbanization has entered an accelerated phase. There are basic problems to be solved for both the urbanization model and prices. In the early stage of development, there will be business opportunities in industries related to transportation, public construction and real estate development. If a good household registration and medical insurance systems can be constructed, in the long run, it should bring positive and sustained consumption and employment to the whole of China.

In terms of trade, a serious imbalance exists between China and the US. The main reasons are global industrial patterns, international division of labor, and differences between the two countries' economic structures and development, which cause US domestic markets to demand imports from emerging markets. China's foreign economic policies have promoted free trade agreements with other countries, and the focus of trade has gradually shifted in the past decade to the Asia-Pacific. Trade frictions with the US have increased. The US has accused China of using trade barriers and promoting exports through unfair trade methods such as low-cost loans, energy subsidies, and tax rebates. The US has invoked Article 301 of the Trade Act of 1974 through executive order, authorizing the Trade Representative Office to initiate an investigation into "China's trade practices," including its threats to broader markets, requiring foreign investors to transfer intellectual property.

In terms of finance, China is still promoting internationalization of the RMB and marketization of interest rates. The RMB has become an important currency for settlements around the world. On October 1, 2016, it was officially included in the IMF's SDR basket. In 2017, after the fourth attempt, A-shares were finally included in the MSCI index. China's "going global" trade policy will gradually gain momentum, complementing the internationalization of the RMB. China faces overcentralization, forming structural issues. In case the risks come to pass, systematic risks may form, quite possibly leading to a financial crisis, affecting financial markets around the world. Therefore, the government is treading carefully, with housing purchase restrictions as an example.

2. Recommendations

In order to enjoy potential business opportunities from these reforms, whether involving overall economic policies or financial reform measures, or even the speed or magnitude or the reform, Taiwanese banks must not only promptly locate the opportunity, making good use of their own strengths and advantages to plan strategies and specific solutions. The recommendations of this study are summarized in the following table:

Table 1: Countermeasures by Banks

Situation	Countermeasures
Government Work Report and Supply-Side Structural Reform	1. Discuss possible business opportunities for future profit 2. Expand scale and capital 3. Strengthen risk management 4. Invest resources and continue to focus on major risks 5. Pay attention to local government issues and avoid minefields 6. Strengthen IT investment in response to the Fintech trend
Seven major FTZs	Study the characteristics and benefits of each FTZ, and adapt to local conditions
RMB risk	1. Prudently avoid RMB exchange risk 2. Keep watching capital control policies
Real estate bubble	1. Continue paying attention to prices and US interest rates 2. Increase risk awareness and pay close attention to relevant policy and GDP trends

Situation	Countermeasures
SOE debt risks	1. Understand the latest developments in Chinese SOE debt for early response 2. Pay close attention to overall Chinese development trends and official policies 3. Establish a credit information system and early risk warning mechanism
Strengthened regulation	1. Understand China's latest regulatory trends for early response 2. Strengthen investment in compliance information technology and personnel 3. The hope of regulation is to return finance to its origin
Trump's tax reforms	1. Watch related follow-up developments in US policy 2. Observe cross-strait industry and business trends for early deployment 3. Banks should strengthen their compliance to meet the future needs of globalization