What You Should Know This Week: CSOP's Weekly China Wrap Up

China's central bank raises interest rates, mirroring the Fed's rate hike decision

The People's Bank of China unexpectedly raised the rates it charges in open-market operations and on its medium-term lending facility, following the Federal Reserve's decision to increase the Fed rate by 0.25%. The costs of 7-day/28-day reverse repurchase agreement, as well as the cost of medium-term lending facility (MLF) funding were raised by five basis points. The move caught investors off guard, given China's central bank had refrained from raising borrowing costs along with earlier Fed rate hikes, such as the one in June of this year.

What are the implications?

Given monetary tightening in the US tends to strengthen the USD and put pressure on emerging market currencies, some argued that a small rate hike in China could help to support the RMB in the short term. Meanwhile, China's leadership is concerned about potential capital outflow after the potential US tax cuts. As China is unlikely to be able to follow suit to match the tax reforms at a similar scale, higher interest rates and tighter capital control may be employed to contain the foreign exchange reserves.
However, policy makers are walking a tight rope between further tightening and slowing economic growth. Today's rate hike is yet another piece of evidence that the leadership is determined to continue the deleveraging process. However, PBOC's smaller adjustment compared to the US may also indicate its reluctance to jeopardize the fragile economic recovery, especially in sectors fueled by ample credit. With three possible Fed hikes expected in the next year, emerging market economies should also consider monetary policy normalization, as one senior PBOC official warned in a recent speech.

China and Russia launches a joint military exercise, colliding with US-South Korea's

China and Russia has launched simulated anti-missile exercises this week, coinciding with the sixth US-led joint military exercises with South Korea which also started this week. China's defense ministry stated drills were aimed at boosting cooperation in defense within the region, suggesting China and Russia were getting prepared for rising tensions with an increasingly contentious North Korea. Meanwhile, South Korea president Moon kicked off his state visit to China, with North Korea expected to be a top topic for discussion.

What are the implications?

Military experts see the exercise is meant to two distinct messages. First is to broadcast to Pyongyang that China and Russia, arguably North Korea's only significant allies, their preparedness and abilities to defend in an event of crisis. Second is towards the US and its allies – in particular South Korea and Japan – with the message that the two socialist nations are also main players in the current situation and they do not approve of continued US influence in the region.

China and Russia have previously protested against US-South Korean military drills. They have also suggested one-to-one demilitarization process between North and South Korea as part of a de-escalation solution. Separately, China has imposed economic bans on South Korea earlier this year including limiting tourist packages, to object to South Korea's deployment of the American anti-missile system THAAD (Terminal High Altitude Area Defense). South Korea meanwhile has contended that THAAD installment is a matter of national security, and the differing side has hardened the bilateral relationship.

Given the situation, North Korea, THAAD, and resuming economic partnership is likely to be the main agenda for South Korean president Moon's state visit to China this week.

Rural Chinese provinces deep in the red for pension payments

Thirteen of China's provincial pensions are unable to meet their payment obligations for the next year, with some already dipping into federal reserves to make payments. On a national level, expenditures grew at a pace of 23.4%, outpacing income growth at 19.5%, according to the 2016 Social Security Development Annual Report. To make up for the growing deficit, the federal government will be launching a pilot program to transferring assets of shares of state-owned enterprises to national pensions. This will help pensions to benefit from dividend and capital gains from government-owned assets. Earlier this year, the federal government also allowed for the first time for pensions to invest into securities, moving from low-risk policies of limiting investments into treasury bills or bank deposits.

What are the implications?

The provinces in the worst financial situations are among the poorest inner provinces, which have been impacted by a combination of an aging population, shrinking work force, and the lingering effects of the one-child policy. Rural provinces have been hit particularly hard, with improvements in health care increasing longevity for the elders, while lack of economic momentum drove the younger populations to larger cities. This has contributed to huge differences in accumulated pensions, with economically strong provinces like Guangdong, which reported having enough capital to make almost 5 years of payments. The overall picture is not rosy however, with pensioners to workers ratio declining rapidly. In 2011, the ratio of pensioners to workers was 1:3.1, which fell to 1:2.8 by the end of 2016. Analysts estimate that by 2050, the ratio will hit as even as 1:1.3, with approximately 30% of the population being made up of retirees. While the government is trying to intervene with the asset transfer program, the eligible enterprises will be limited, and China is likely to continue to a large economic and social dilemma in the social security aspect.

Index definition:

1. The FTSE China A50 Index is the benchmark for investors to access the China domestic market through A Shares – securities of companies incorporated in mainland China and traded by Chinese and institutional investors under the Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investor (QFII & RQFII) regulation. Note that one cannot invest directly in an index

2. The CHINEXT index is China's Nasdaq-like barometer of high-tech stocks. Note that one cannot invest directly in an index

3. The MSCI China Index captures large and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 150 constituents, the index covers about 85% of this China equity universe. Note that one cannot invest directly in an index

4. Bloomberg's Global Aggregate + China Index combines the Global Aggregate Index with the treasury and policy bank component of the China Aggregate Index. The EM (Emerging Market) Local Currency Government + China Index combines the EM Local Currency Government Index and treasury component of the China Aggregate Index. Note that one cannot invest directly in an index

5. Citibank's World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment grade sovereign bonds. The JPMorgan Emerging Market Bond Index (EMBI) are a set of three bond indices that track bonds in emerging markets. Note that one cannot invest directly in an index

6. The Hang Seng China Enterprises Index is a free-float capitalization-weighted index comprised of H-Shares listed on the Hong Kong Stock Exchange and included in the Hang Seng Mainland Composite Index. Note that one cannot invest directly in an index

Institutions:

1. PBOC: People's Bank of China
2. SOE: State-owned enterprise
3. IMF: International Monetary Fund
4. CBRC: China Banking Regulatory Commission
5. CIRC: China Insurance Regulatory Commission
6. CSRC: China Securities Regulatory Commission
7. SAFE: State Administration for Foreign Exchange
8. ICBC: Industrial and Commercial Bank of China
9. EU: European Union
10. G20: An international forum for the governments and central bank governors from 20 major economies
11. G7: An international forum for the governments and central bank governors from 7 major economies
12. UAE: United Arab Emirates
13. SSE: Shanghai Stock Exchange
14. LSE: London Stock Exchange
15. AIIB: Asian Infrastructure Investment Bank
16. WTO: World Trade Organization

Currencies:

1. RMB: Renminbi, the national currency of China

2. USD: US Dollar, the national currency of the United States
3. GBP: Pound Sterling/Great British Pound, the national currency of the United Kingdom
4. JPY: Japanese Yen, the national currency of Japan
5. EUR: Euro, the official currency of the Eurozone
6. HKD: Hong Kong Dollar, the national currency of Hong Kong
7. USDCNH: Abbreviation for the US offshore Dollar/RMB currency pair

Others:

1. IPO: Initial public offering
2. SPO: Secondary Public Offering
3. MoM: month over month
4. YoY: Year over year
5. GDP: Gross Domestic Product
6. EM: Emerging Market
7. Bps: Basis points
8. FX: Foreign Exchange
8. OTC: Over-the-counter
9. GDP: Gross domestic product
10. ETF: Exchange-traded fund
11. FATCA: Foreign Account Tax Compliance Act
12. TPP: Trans-Pacific Partnership
13. SDR: Special Drawing Right, an international reserve asset
14. OBOR: One Belt, One Road
15. RCEP: Regional Comprehensive Economic Partnership