ECONOMIC ANALYSIS

China | Reemerging market selloffs indicate rising financial risks

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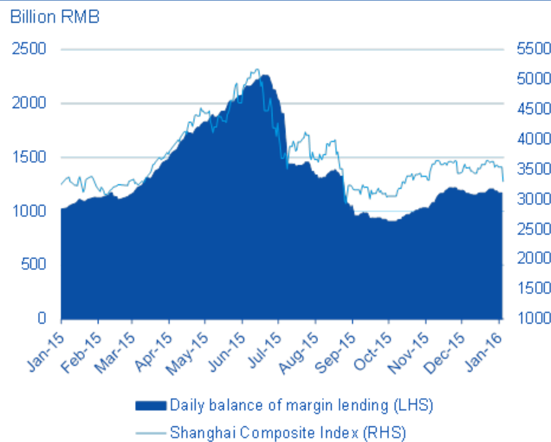
China's financial markets welcomed the New Year with another round of selloffs on the first trading day of 2016. The CSI 300 index, which is the benchmark equity index in China's domestic stock market and consists of large-capitalization listed firm in Shanghai and Shenzhen stock exchanges, dipped by -7% by at the opening of the afternoon trading session and triggered the 'circuit breaker' which starts to be effective from today. The selloff in the equity market also led to a concursion of the currency markets. In the time of writing, the onshore USDCNY declined to 6.53, the lowest level since 2010 November while the offshore USDCNH depreciated further to a record low of 6.63. The drama in equity and currency markets today points to mounting risks in China's financial sector, which have been rapidly accumulated with the country's stellar growth over the past several years but are to unfold amidst the ongoing economic deceleration. Although the authorities seem to be fully aware of these challenges and start to mend off its regulatory framework (See PBOC launching a new macro-prudential assessment system), they still need to walk a fine line between preventing any systemic financial risk on one hand and pressing ahead with much-needed structural reforms on the other hand.

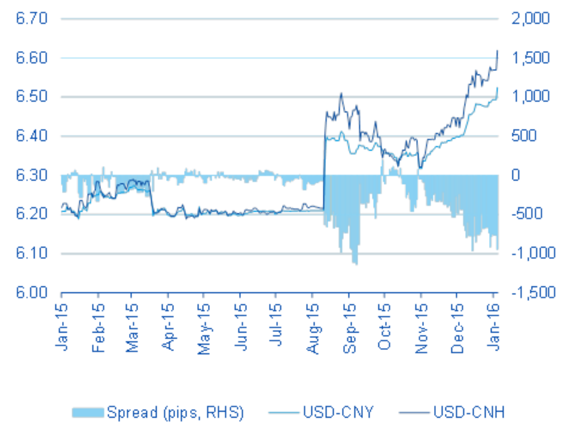
- **A flawed design of China's 'circuit breaker' is likely to be the culprit behind the equity market sell-off.** Under the newly introduced circuit breaker rules, which were announced last month and become effective from today, a ±5 % movement in the CSI 300 will trigger a 15-minute halt for the trading of stocks, options and index futures, while a move of ±7 % will close the market for the rest of the day. The introduction of these circuit breaker rules is intended to alleviate the market panic and prevent the irrational 'herding' behaviors of investors during market turmoil as happened in June-July 2015. However, as some experts acutely pointed out previously, the design of China's circuit breaker rules is subject to two critical flaws: (i) the first threshold (±5 %) is set too low given the high volatility of China's stock market and (ii) the gap between the first threshold (±5 %) and the second threshold (±7%) is too narrow. Today's market performance has vindicated the above view as an earlier hit of the first threshold (as well as the triggered 15-minute halt) failed to arrest the market selloff and led to the hit of the second threshold in a very short time after the trading re-opening.
- **More challenges are lying in the road ahead.** To a certain extent, the drama in this year's first trading day reminds investors of the mounting financial risks amid the ongoing growth deceleration. On top of the excessive movements in the stock market and currency markets, China's bond market also looks vulnerable if the authorities' beefed-up efforts of overcapacity elimination lead to a wave of bond defaults. Moreover, a number of risks, including credit risk, maturity mismatch risk and liquidity risk, could break out in China's giant shadow banking sector and spill over to the formal banking sector. The authorities seem to be fully aware of these challenges. The PBoC recently launched a new macro-prudential assessment system to address risks in the financial system, which in essence gives the central bank power of sole regulator. Nevertheless, the authorities need to strike a balance between maintaining financial stability and advancing structural reforms.

Figure 1
Equity market selloff reappeared in this year's first trading day



Source: WIND and BBVA Research

Figure 2
Price differential between onshore and offshore RMB is widening



Source: Bloomberg and BBVA Research

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