

# China: Vulnerability sentiment improved notably in May

Sumedh Deorukhkar / Alvaro Ortiz / Tomasa Rodrigo / Le Xia

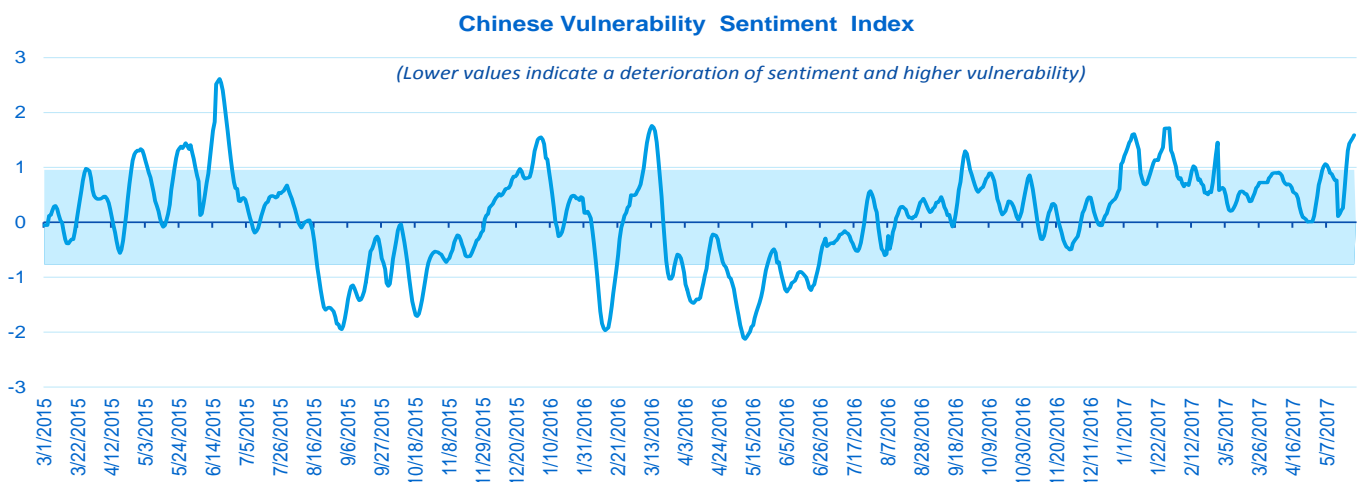
31 May 2017

Our China Vulnerability Sentiment Index (CVSI) improved notably over the past month, led by Housing, SOE and Shadow Banking component, which together offset a marked deterioration in the Exchange Rate Vulnerability Index. In the context of China's sovereign ratings downgrade by Moody's last week, the improvement in CVSI is a harbinger of underlying investor confidence that macro-financial headwinds facing China remain manageable, still, as anchoring financial stability assumes top policy priority.

## Robust SOE earnings, policy prudence, underpinned China's vulnerability sentiment

The sharp jump in CVSI (Figure – 1) observed over the past month can be attributed to two key factors – 1) Solid earnings growth revealed by China's State Owned Enterprises and 2) A step up in policy efforts to quell financial stability risks. China's State Owned Enterprises reported a solid 59% y/y profit growth in the first four months of 2017, led mainly by gains in oil, petrochemical, coal and steel industries. However, in a word of caution, such gains in SOE Vulnerability index (Figure – 2 & 7) aren't likely to sustain over the next month. The recent decline in commodity prices and tighter policy oversight will show slower SOE profit growth for May (data is released with a month's lag). Meanwhile, Housing Bubble Index (Figure – 3) for China improved as authorities expedited efforts to stem speculative house price increases and stabilize the property market. Improvement in Shadow Banking Vulnerability Index (Figure – 4) reflects a step up in efforts by regulators to enhance regulatory oversight in the sector. The CBRC recently introduced a stringent unified regulatory framework to quell asset management risks while the PBOC maintained its "prudent" monetary policy stance and implemented a new regulatory framework of Macro Prudential Assessment, enforcing banks to include many previously off-balance-sheet activities into their books. April credit data confirmed that 'entrusted loans', a shadow financing proxy, contracted for 1st time in a decade (-4.8 bn ¥). The deterioration in Exchange Rate Vulnerability Index (Figure – 5) suggests that despite a relatively stable Yuan, and incremental improvement in China's FX reserves, risk of capital outflows remains an overriding concern for China. To underpin financial stability, PBOC, last week, added a 'counter-cyclical adjustment factor' to its model guiding daily USDCNY midpoint fixing. We believe that by leaning towards an overvalued exchange rate (Figure – 6), authorities have, in effect, raised their stakes on the effectiveness of ongoing deleveraging campaign.

Figure 1. China Vulnerability Sentiment Index (CVSI)

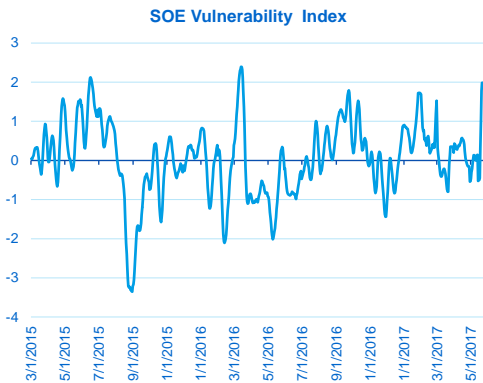


Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC and Wind

## In sum...

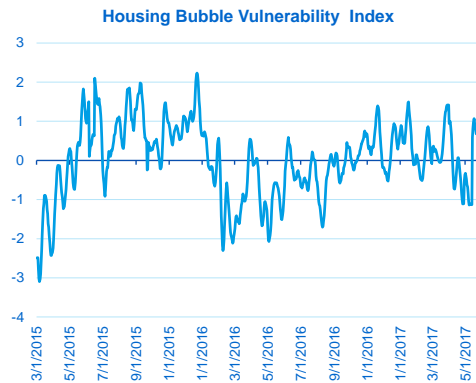
The marked improvement in China Vulnerability Sentiment Index (CVSI) over the past month needs to be tempered by the uncertainty surrounding the effectiveness of broadbased policy reforms that are currently being implemented. The overhang of high conomywide debt and a misallocation of capital leaves the economy vulnerable to abrupt shocks despite ongoing policy reforms.

**Figure 2. SOE Vulnerability Index**



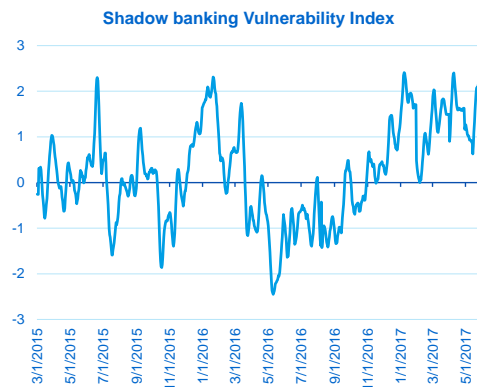
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

**Figure 3. Housing Bubble Vulnerability Index**



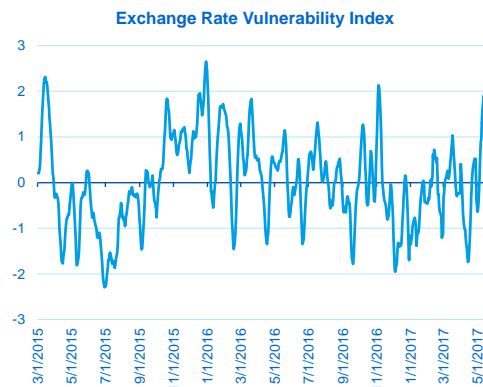
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

**Figure 4. Shadow Banking Vulnerability Index**



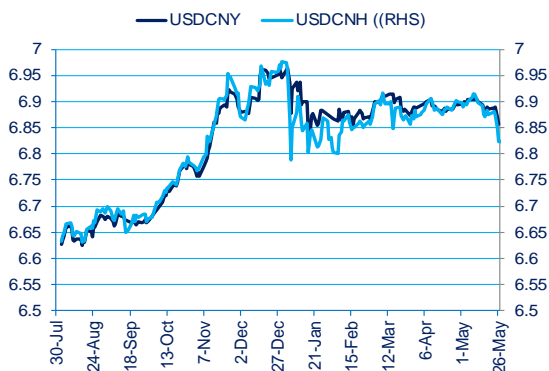
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

**Figure 5. FX Speculative Pressure Vulnerability Index**



Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

**Figure 6. Recent CNY fixings have been stronger**



Source: BBVA Research, Bloomberg

**Figure 7. SOE Sentiment improved vs. last month**



Source: BBVA Research, Bloomberg

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