

# China: Vulnerability sentiment ends 2017 on a high note

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03 January 2018

Our China Vulnerability Sentiment Index (CVSI) ended 2017 on a high note, extending previous gains, underpinned by the shift in policy focus towards quality of growth, PBOC’s prudent monetary policy stance, a stable yuan and ongoing efforts to curb risks to financial stability emanating from housing, SOE and the shadow banking sector. While the SOE & Housing vulnerability indices saw slight deterioration, the Shadow banking vulnerability index held on to its gains while Exchange rate vulnerability index recovered.

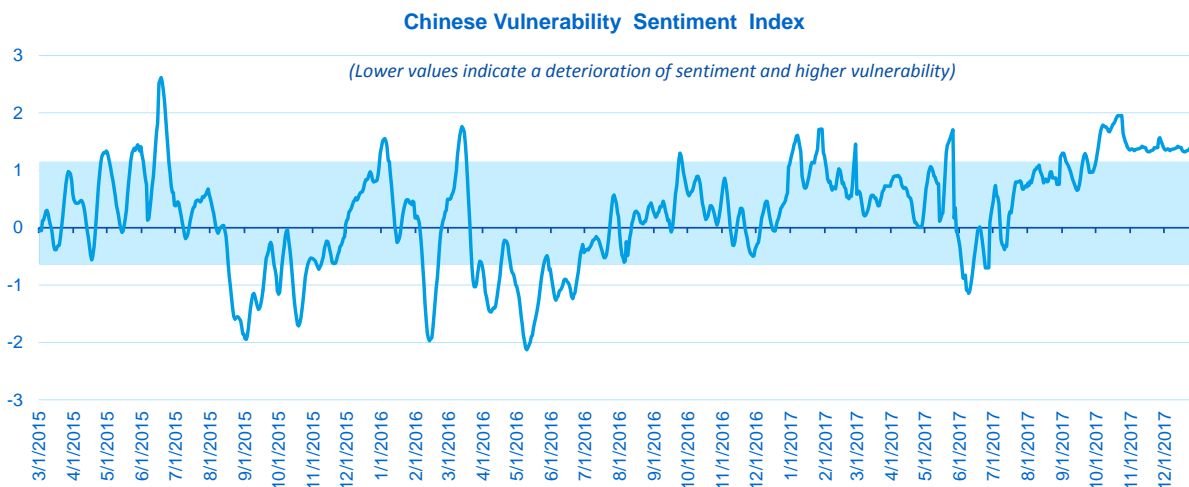
## Sustaining recent robust gains in CVSI is a challenge for authorities in 2018

Our CVSI extended its robust gains in December, closing 2017 on a high note, marking the sixth straight month of positive print (Figure – 1). Digging deeper, our SOE & Housing bubble vulnerability indices saw slight deterioration (Figures 2, 3 & 7). On the other hand, Shadow banking vulnerability index held on to its gains (Figure – 4) while Exchange rate vulnerability index recovered (Figure – 5). We identify five key determinants of CVSI in 2018. First, policymakers’ tolerance for slower yet quality growth in their bid to curb financial risks will be tested. The annual National People’s Congress (NPC) in early March as well as policy communique from regulators will be eyed for signals on China’s 2018 growth target. The share of private investments in FAI is key to gauge growth quality. Second, PBOC’s monetary policy stance will be watched. We expect PBOC to maintain its prudent monetary policy stance in 2018 while fiscal policy remains growth supportive. While PBOC is unlikely to cut benchmark interest rates, it should continue to fine-tune interbank liquidity using OMOs and adjust money market rates, particularly against the backdrop of rising US interest rates. That said, targeted RRR cuts to aid small businesses cannot be discounted. Third, macro-prudent policy and tight regulatory oversight, especially on housing market, is expected to continue as curbing financial stability risk remains top priority. Fourth, China’s financial liberalisation theme will be eyed in the context of Yuan stability (Figure – 6). FX reserves changes will test regulators tolerance for capital flows and in turn their actions related to capital controls. Finally, China’s handling of international relations and geopolitical issues, namely trade tensions with US, concerns over North Korea & the South China Sea will impact CVSI in 2018.

### In sum...

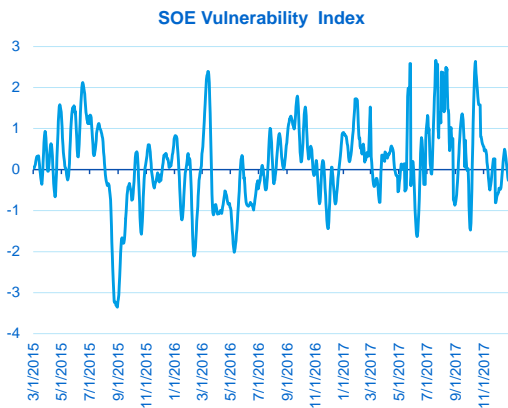
The improvement in CVSI is reassuring. However, China’s debt burden continues to rise, albeit at a slower pace. Chinese leadership is aware of the risks posed by financial fragilities and is committed to tackle them. With no room for complacency, markets will test whether policymakers live up to their reform promise in 2018, especially given a slowing growth outlook.

**Figure 1.** China Vulnerability Sentiment Index (CVSI)



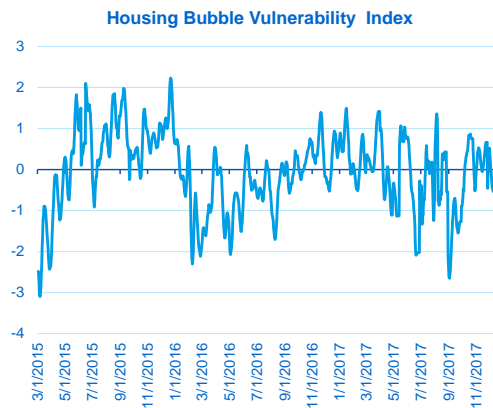
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC and Wind

**Figure 2. SOE Vulnerability Index**



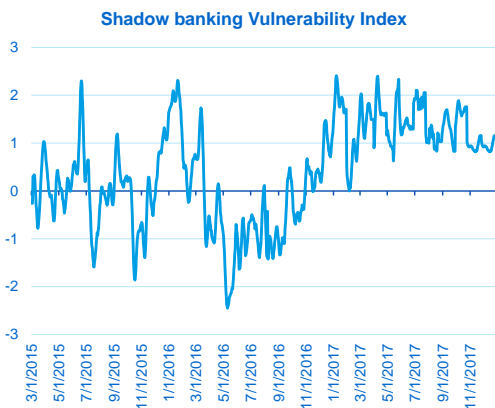
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

**Figure 3. Housing Bubble Vulnerability Index**



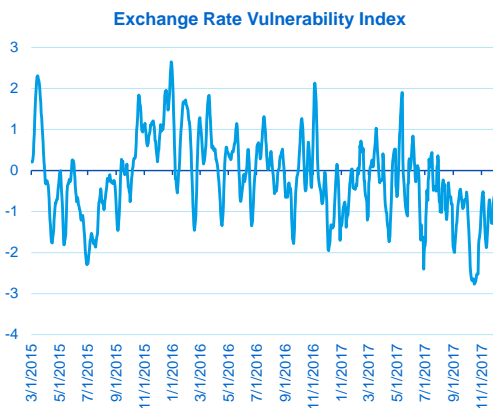
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

**Figure 4. Shadow Banking Vulnerability Index**



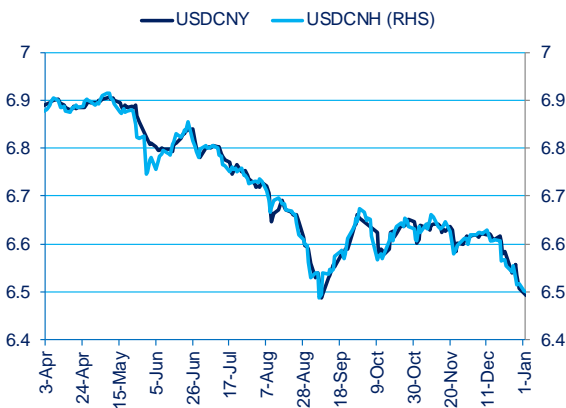
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

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



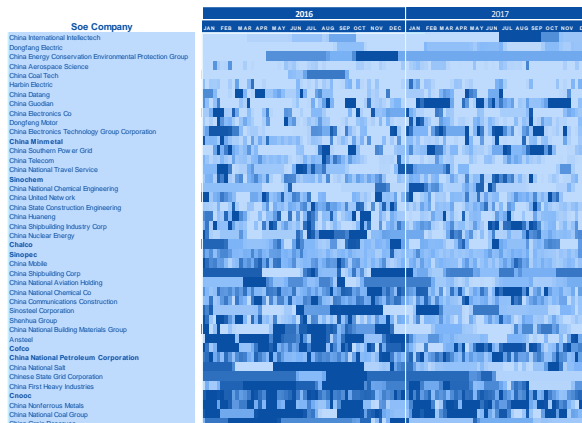
Source: BBVA Research based on figures by Gdelt, Bloomberg, CEIC, Wind

**Figure 6. Chinese Yuan ended 2017 on a strong note**



Source: BBVA Research, Bloomberg

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



Source: BBVA Research, Bloomberg

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