Chinese New Year: Year of Dragon

Ahmet Goncu
Xi'an Jiaotong-Liverpool University
Department of Mathematical Sciences
Suzhou, 215123, China
goncuahm@gmail.com

The Spring Festival, which is the most important traditional holiday in China, has started on January 21st. Financial markets in mainland China will be closed between 21st and 29th of January. Chinese New Year or the so called Spring Festival refers to the start of the New Year according to the Chinese lunar calendar. During this festive time in China, spending is particularly high in which people often buy presents, decorations, material, food, and clothing for their families. A reunion dinner is held on New Year's Eve where members of the family gather for celebration. During this time of the year hundreds of millions of Chinese go back their hometowns for family reunions. Therefore, at this time of the year people forgot about the worries of global financial problems or possible risks in Chinese economy for a while.

Meanwhile, the preliminary HSBC Purchasing Managers' Index (PMI) was 48.8 in January, a third consecutive reading below 50, indicating a slowdown. That indicates a persistent weakness in the manufacturing sector that may invoke an easing of the government's tight monetary policy.

HSBC Holdings Plc said that the contraction in manufacturing production is likely to continue in the first few months of this year, indicated by continued declines in output and new-order indices. The number was 48.7 in December and 47.7 in November. It is likely that growth will moderate further during 2012. Although in December, data from the National Bureau of Statistics (NBS) showed that the year-on-year growth in industrial production rebounded slightly to 12.8 percent from 12.4 percent in November, "the ongoing slowdown in investment and exports implies more barriers to growth".

According to the National Bureau of Statistics, the contraction in manufacturing followed a sharp drop in GDP to a three-year low, on a quarterly basis, of 8.9 percent in the last quarter of 2011, dragging full-year economic growth down to 9.2 percent from 10.4 percent recorded in 2010. Many economists expect that during the first six months of 2012 we might see the bottom level of quarterly growth.

World Bank downgraded its growth estimate from 8.6% to 8.4% due to weakening European export markets for the Chinese economy in 2012.

In December 2011, China saw the second month of net forex sales. According to the Sate Administration of Foreign Exchange (SAFE) Chinese lenders bought $142.5 billion on behalf of clients in December, while they sold $157.8 billion, marking the second monthly deficit. The increased demand for foreign currency is mainly due to the market's perception that Yuan's appreciation will slow down or even stop during 2012. Many economists expect roughly a 2% percent appreciation of Chinese Yuan against USD in 2012.

During 2011, Chinese Yuan appreciated about 5% against USD. We should also note that USD appreciated against Euro as well. Therefore, Yuan actually appreciated significantly against a basket of major currencies. This situation will be different in 2012. During the first weeks of January Yuan depreciated and Central Bank is giving the signs that during 2012 Yuan might not appreciate significantly. Hence, we might see a period of net forex sales during 2012. Together with slowing down inflation, this will put less pressure on the Central Bank. Depending on the speed of slowdown financial markets are expecting monetary policy to be more flexible than in 2011. At the same time bank lending might increase together with higher government spending to support growth.

Chinese government is aware that a quick drop in growth rates will put too much pressure on the economy and property prices. Therefore, while keeping restrictions on property sales and projects, it is likely that government will take measures to prevent a rapid drop in growth rates during the first two quarters of 2012.

In 2012, we expect the government to increase bank lending by at least 8 trillion yuan ($1.27 trillion), likely to be supported by two or three additional cuts of the reserve-requirement ratios.

Average property prices in the country's 100 biggest cities fell further last month, sliding 0.25 percent from November. The price declines are still marginal, however further declines were likely as long as the central government maintained curbs on housing purchases. December was the fourth consecutive month in which the average home price weakened across the country. Property prices in the 100 cities averaged 8,809 yuan ($1,399) a square meter (sq m) in December, according to a report released on Wednesday by SouFun Holdings Ltd. Among the 100 cities monitored, 60 saw a month-on-month price drop, and three cities' home prices were unchanged. Year-on-year, the 100 cities' home prices rose 2.86 percent in December, 1.2 percentage point less than in November. Average prices in the top 10 cities stood at 15,588 yuan a square meter, a month-on-month drop of 0.48 percent. Property prices in Beijing fell 0.25 percent month-on-month, while those in Shanghai slid 0.42 percent. Chengdu in Sichuan province had the largest month-on-month fall of 1.1 percent among the 10 major cities, a category that includes Beijing, Shanghai, Guangzhou and Shenzhen.

During the latest Central Economic Work Conference, an annual gathering of Chinese leaders to decide economic policy for the next year, the government reiterated its resolution to make home prices return to a reasonable level.

China's central bank issued guidelines to regulate foreign investors' Yuan-denominated investment activities in China in preparation for a possible backflow of Yuan into the mainland's equity markets.

New guidelines on the implementation of the Renminbi Qualified Foreign Institutional Investors (RQFII) program by the People's Bank of China (PBOC), the country's central bank, came just several days after the PBOC approved a 10.7-billion-yuan ($1.7 billion) investment quota for the first RQFII pilot program.

In the next part, we briefly introduce the Qualified Foreign Institutional Investors (RQFII) program.

Qualified Foreign Institutional Investors (QFII) Program

The Qualified Foreign Institutional Investor（QFII）program is a Chinese program that was launched in 2002 to allow licensed foreign investors to buy and sell **Yuan-denominated "A" shares** in China's mainland stock exchanges (in Shanghai and Shenzhen stock markets). This program is part of the liberalization of Chinese financial system and supporting Yuan to be international currency.

With the introduction of QFII program Chinese stock markets partially opened up to foreign institutional investors. Chinese mainland stock exchanges were previously closed off to foreign investors due to China's exercise of tight capital controls which restrict the movement of assets in-and-out of the country. As of February 2009, a total of 79 foreign institutional investors have been approved under the QFII program. Foreign access to China's yuan-denominated "A" stocks are still limited, with quotas placed under the QFII program amounting to $30 billion. Currently there are no financial institutions from Turkey that are included in the QFII program.

To qualify as a QFII, the candidate must: has stable finance, good credibility, meet the minimum asset scale set by China Securities Regulatory Commission（CSRC), the number of staffs meet the requirement set by the authority in its own country or area, has healthy governing structure and complete internal control system, received no significant punishment in the last 3 year, candidate's home country has complete legal and supervision system, and its home country or home area has signed Memorandum of Understanding（MOU） with CSRC, and maintains effective supervision cooperation, other requirements set by CSRC based on prudence.

Q: What is QFII?

On November 5, 2002 the China Securities Regulatory Commission (CSRC) and the People's Bank of China (PBOC) introduced the QFII (Qualified Foreign Institutional Investor) program as a provision for foreign capital to access China's financial markets. Chinese QFII regulations relax some capital controls and allow foreign institutions to invest in RMB-denominated equity and bond markets. Indeed, QFII is a Chinese brokerage business, which allows qualified foreign institutions to trade Chinese A-shares via special accounts opened at designated custodian banks, for their clients. The QFII mechanism not only further opens China's securities markets, but also gives foreign investors an opportunity to take position on those markets and buy stakes in Chinese companies, thus sharing in China's phenomenal growth.

Q: What financial instruments can a QFII invest in?

Shares listed on China's stock exchanges (excluding B shares); Treasuries listed on China's stock exchanges; Convertible bonds and enterprise bonds listed on China's stock exchanges; Other financial instruments approved by the CSRC; Shares held by each QFII in one listed company should not exceed 10% of total outstanding shared of the company (a rule also enforced for domestic investors); Total Shares held by all QFIIs in one listed company should not exceed 20% of total outstanding shares of the company.

Q: Who can become a QFII?
Overseas fund management institutions, Insurance companies, Securities companies, other assets management institutions which have been approved by the CSRC. In order to encourage medium and long-term investments, the CSRC stated that it will give preference to institutions managing closed-end Chinese-focused funds, or pension funds, insurance funds and mutual funds with good investment records in other markets.

Q: Who Oversees the QFII Program?
The China Securities Regulatory Commission (CSRC) and State Administration of Foreign Exchange (SAFE) are the regulators of the securities investment activities conducted by QFIIs. They are responsible for overseeing all transactions and conducting annual inspections on QFIIs. SAFE is responsible overseeing business tied with foreign exchange operations, such as the approval of the QFII investment quotas, issuance of the foreign exchange certificate, supervision of account management and foreign exchange settlements (as specified in Foreign Exchange Control on Securities Investments in China by Qualified Foreign Institutional Investors Tentative Provisions). The CSRC is the approval authority for QFII status. It interprets the rules regarding QFII and takes the role of a general regulator.

The QFII applicant must meet the following criteria:
Sound financial and credit status, Risk control indicators meet the requirements set by laws and securities authorities under applicant's home jurisdiction, Sound management structure and internal control system.

If a fund management institution: It must have operated its fund business for over 5 years with the most recent accounting year managing assets of not less than $10 billion.

If an insurance company: It must have operated its insurance business for over 30 years with paid-in capital of not less than $1 billion and manage securities of not less that $10 billion in the most recent accounting year.

If a securities company: Must have operated securities business for over 30 years with paid-in capital of not less than $1 billion and manage securities assets of not less than $10 billion in the most recent accounting year.

If a commercial bank: It must rank among the top 100 of the world in terms of total assets for the most recent accounting year and manage securities assets of not less than $10 billion.

Under new regulations, currently waiting approval by the CSRC, requirements on investor's qualifications, border securities and investment percentage, capital remittance and sub-account opening will be downgraded allowing more QFII's to enter the market.

Application Process
The applicant must mandate a custodian and a broker for their securities trading.

The elected custodian files the application for QFII qualification and investment quota to the CSRC and SAFE respectively. The current QFII investment quotas range from $50 million to $800 million. There are currently 11 banks in China that are qualified for the custodian business. They include 7 Domestic Qualified Custodians: Bank of China, China Construction Bank, Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of Communications, China Merchants Bank, and China Everbright Bank. Foreign Qualified Custodians: Standard Chartered Bank, HSBC, Citibank, Deutsche Bank. The custodian bank offers securities and cash clearing services to QFIIs that have received authorization from Chinese regulators.

A custodian acts as the primary communication channel between the QFII and the Chinese authorities. They service foreign exchange and cash settlement needs of the QFIIs and are in charge of the safekeeping of securities, receiving of dividend and interest payments, and reporting to the CSRC and SAFE about the status of the account and compiling the QFII's annual report. After obtaining approval from the CSRC and the investment quota from SAFE, the QFII must remit into China within 3 months the full amount of its initial investment in foreign currency in accordance with the quota set by SAFE. This capital is then converted into RMB and deposited with the custodian.