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Evaluating the Financial Risks in China

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Overview

Despite its size, direct global exposure to the Chinese financial system is currently still small. A regulatory wall around the Chinese financial system is largely responsible for this.

A financial crisis in China is likely to lead to a heighten level of capital flight. The Chinese authorities and central bank would be forced to offset downward pressure on the yuan–dollar exchange rate buy selling U.S. denominated assets (i.e., primarily U.S. Treasuries). This, however, is unlikely to result in a significant fall in U.S. bond prices (i.e., a rise in U.S. interest rates) given the dollar's solid safe-haven status in times of global financial crises.

Most of the fallout will be within Asia, where trading and lending have the strongest links and where credit has been growing the fastest globally since the 2008–2009 financial crisis.

The Current State of the Chinese Economy—A Brief Overview

There exists great skepticism about the accuracy of many Chinese macroeconomic indicators. There are significant reasons for this perception. First of all, any government exercising such a significant role in managing the direction of an economy is highly likely manipulating official statistics. In a nation of almost 1.4 billion people, quarterly gross domestic product (GDP) figures are often released just 14 days after the end of the quarter with no subsequent revisions. (In the U.S., GDP figures undergo two revisions, sometimes significant, spanning out 60 days after the first release.)

The headline figures often conveniently match Beijing's target figure. To admit the economy was growing at a 4 percent pace could cause a loss in confidence in the relatively early 10-year tenure of Xi Jinping. There are plenty of inconsistencies. While GDP was reported to grow at a 6.8 percent in 2015, electricity consumption rose by only 0.5 percent. These two figures are simply not consistent.

More ominous has been the level of fixed asset investment (i.e., residential and commercial construction, physical infrastructure, etc.). While it has fallen very modestly as a share of GDP recently, since the global financial crisis, it has run at approximately 45 percent of GDP. Historically speaking, this level is unprecedented among the emerging market economies, even those in East Asia during their rapid growth periods.

This elevated level of fixed investment has long passed its expiration date. Many industries such as steel, cement, rare earth minerals, energy refining and housing are operating at three-quarters capacity. This is precisely why wholesale prices have fallen for three consecutive years.

A large drop in fixed-asset investment (as a share of GDP) will be a necessity. First, the return on these investments has been rapidly declining. The amount of capital needed to generate an extra dollar of income has more than doubled over the past decade. Even bringing this figure down to 30 percent of GDP is highly likely to produce significantly slower economic growth from current levels.

Reflecting the drop in overall efficiency, the contribution of total productivity to GDP has been falling in China. From 1991–2000 it averaged 5.9 percent then declined to an annual average of 3.6 percent during the past five years (2011–2015). To reach a GDP growth target of 5.5 percent to 6.5 percent per year, multifactor productivity growth will need to contribute to 40 percent to 50 percent of GDP growth moving forward.

China's Debt

China's total debt (household, corporate, government) is now much higher than in other developing economies and comparable to levels in the U.S. and the eurozone. While the size is a concern, what is more troubling is the speed at which debt has accumulated. It was approximately 150 percent of GDP in 2007 (a year before the crisis), and is now approximately 250 percent to 300 percent of GDP.

The economy's debt load has more than tripled over the past seven years. New borrowing increased by Rmb 6.2 trillion in the first quarter of 2016, the largest three-month increase on record.

Roughly two-fifths of new debt is swallowed by interest on existing loans. Less credit is going to good firms for productive uses.

Rising Defaults on the Way

It is impossible for China to deploy all the capital productively over a short period of time.

It now takes nearly four yuan of new borrowing to generate one yuan of additional GDP, up from just over one yuan of credit before the financial crisis.

Rising debt levels cause financial distress on borrowers which lead to slower growth before defaults even begin increasing.

China could experience a balance-sheet recession similar to Japan's. When corporate debt reaches a critical level, conventional monetary policy losses its effectiveness because companies focus on paying down debt instead of borrowing at lower interest rates.

Official data has non-performing loans at just 1.7 percent of total loans. This figure grossly underestimates the current stock of "bad" loans.

One of Beijing's new strategies to handle this problem is a debt-equity swap, where banks could write off problem company loans in return for taking equity stakes in them.

Seeking to become less reliant on bank borrowing, Chinese corporations have aggressively tapped the bond market. At $900 billion, it is one of the largest in the world.

Approximately 85 percent of China's bond issuers have AA ratings or above by domestic rating agencies, compared to Moody which rates only 3 percent of global issuers so highly.

The Shadow Banking System

Five years ago, the Chinese shadow banking system was primarily driven by companies unable to secure traditional bank loans. Today, the driver is from ordinary people looking for higher rates of returns.

China's shadow banking system is estimated to be at least two-thirds of GDP. As long as banks do not guarantee the principal of these products, they do not have to report them on their balance sheets. In essence, they are a hidden balance sheet.

One big difference is that the government guarantees bank deposits while shadow lenders are supposed to stand on their own.

China's shadow banking system has become large, but until now, it has avoided creating products similar to the mortgage-backed securities like in the U.S. before the financial crisis. Banks with the largest shadow loans are mid-sized institutions. Wealth Management Products (WMPs) account for about 15 percent of deposits at the largest banks but over 40 percent at mid-tier banks.

Liquidity Issues

Banks are increasingly relying on short-term funding from the sale of high-yielding wealth management products instead of stable deposits. This funding can quickly evaporate when defaults rise. It is probably only a matter of time until banks are unable to fund all their assets safely.

Banks are becoming more reliant on WMPs, where they pay higher returns in lieu of short-term deposits and invest these in long-term assets. This causes a mismatch in duration. China traditionally restricted bank loans to less than 75 percent of their deposit base, but that figure is now approaching 100 percent.

The average maturity of WMPs is only 113 days, but bank loans have much longer maturities, meaning that banks are forced to constantly sell new WMPs for funding.

Global and U.S. Financial Exposure

Since the 2008–2009 global recession, China has accounted for roughly one-third of global economic growth, by far the highest in the world. With a GDP of roughly $11 trillion (current prices), the second largest in the world after the United States, any economic slowdown in this Asian juggernaut is bound to have enormous global consequences.

Since 2010, the rate of economic growth in China has decelerated from a 9.3 percent pace in 2011 to 6.8 percent in 2015 (and the accuracy of the latest figure is in serious question). The question is what impact a further slowdown in China would have on the U.S. economy.

There are three primary channels in which a significant slowdown in China could impact the U.S. economy. The first is through trade. In 2015, China was America's third largest export market, after Canada and Mexico, respectively. This was valued at $116.2 billion, a 50 percent increase since 2008. Exports to China accounted for 7.7 percent of total U.S. exports in 2015, not an inconsequential figure but not devastating to U.S. export revenue in the event of a further Chinese stall in growth. (Chinese exports to the U.S. were $481 billion in 2015.)[1]

The second channel is financial. The Chinese are now the largest holder of U.S. debt (after Japan), standing at $1.2 trillion in April 2016. This currently represents 20 percent of total foreign holdings.[2]

In the event of a further slowdown in the Chinese economy, the government may want to sell some of these securities for economic stimulus. This could lead to a fall in U.S. bond prices (i.e., a rise in domestic interest rates), depressing domestic investment. This impact has been discussed extensively and largely exaggerated for two reasons. First, the Chinese are unlikely to liquidate a large portion of their U.S. Treasury holdings because it might lead to a capital loss on their existing holding. Second, U.S. Treasuries are the most liquid and coveted securities in the world. In the event of an economic crisis, investors would flee toward Treasuries. The recent economic crisis illustrates this.

The third channel is largely a positive one. The slowdown in the Chinese economy has significantly depressed global commodity prices. Despite the shale oil revolution, the U.S imported 9.4 million barrels of petroleum per day in 2015. While the U.S. exported 4.8 million barrels per day in 2015, the net impact for the U.S. economy was positive.[3]

[1]U.S. Census Bureau, "Top Trading Partners – December 2015)," https://www.census.gov/foreign-trade/statistics/highlights/top/top1512yr.html (accessed July 12, 2016).
[2]U.S. Treasury, "Major Foreign Holders of Treasury Securities (in billions of dollars)," June 15, 2016, http://ticdata.treasury.gov/Publish/mfh.txt (accessed July 12, 2016).
[3]U.S. Energy Information Administration, "Frequently Asked Questions," April 1, 2016, http://www.eia.gov/tools/faqs/faq.cfm?id=727&t=6 (accessed July 12, 2016).

So what is the likely net impact? According to the Organization for Economic Co-operation and Development (OECD), a 2 percent decline in Chinese domestic demand growth will cause a decrease in U.S. GDP growth rate by approximately 0.3 percent.[4]

Bottom line? With an economy cruising along at a lackluster 2 percent rate of growth, this drop is not insignificant but also not traumatic.

In terms of the Chinese economy, if the past seven years have taught us anything, it is that financial crises typically result in a period of protracted slow growth. It already appears that China may be entering the early stages of this correction. How the Chinese Communist Party reacts to it will change the future of global geopolitics.

[4] Elvin Mirzayev, "Impact of the Chinese Economy on the U.S. Economy," Investopedia, July 29, 2015, http://www.investopedia.com/articles/investing/072915/impact-chinese-economy-us-economy.asp (accessed July 12, 2016).