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CHI TIME

CHINA IN CRISIS?

Everything will be okay in the end. If it's not okay, it's not the end.

John Lennon

Many observers believe that China is in a financial and economic meltdown. Such a concern is causing anxiety and panic everywhere. China is the world's second largest economy and largest trading nation. Given its growing economic influence around the world, bearish observers clearly think that when China sneezes, the rest of the world may catch a cold.

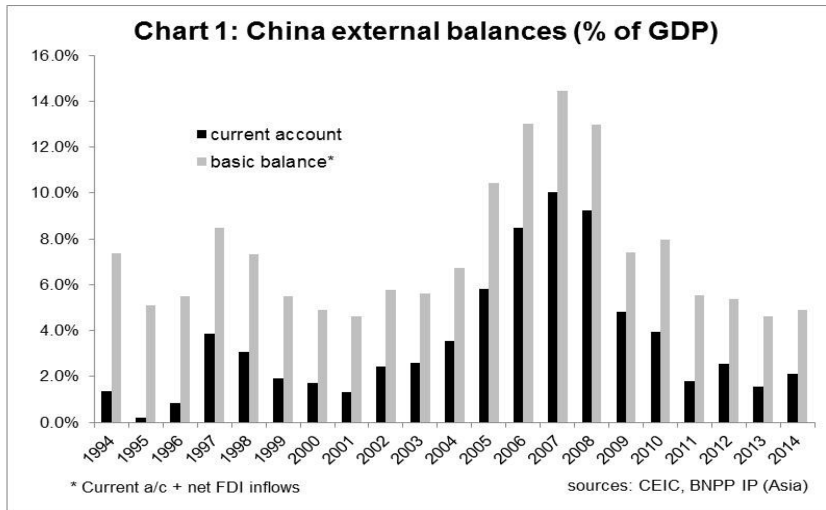
But what do the facts tell us about this gloomy narrative?

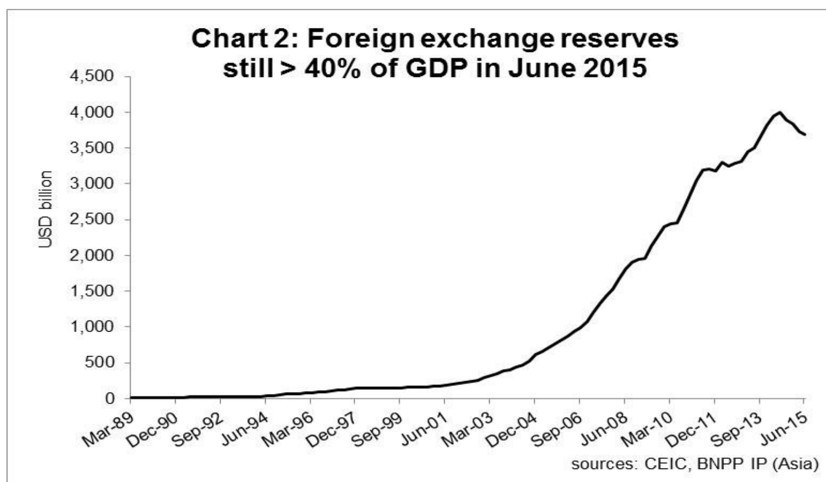
Essentially, there are two kinds of financial crisis: 1) an external account crisis, which arises when foreign investors/creditors lose confidence in a country's economic fundamentals and profligate government, or 2) a banking crisis, which usually stems from the wholesale market funding an asset bubble that aggravates a country's bank balance-sheet mismatch problem when the bubble bursts.

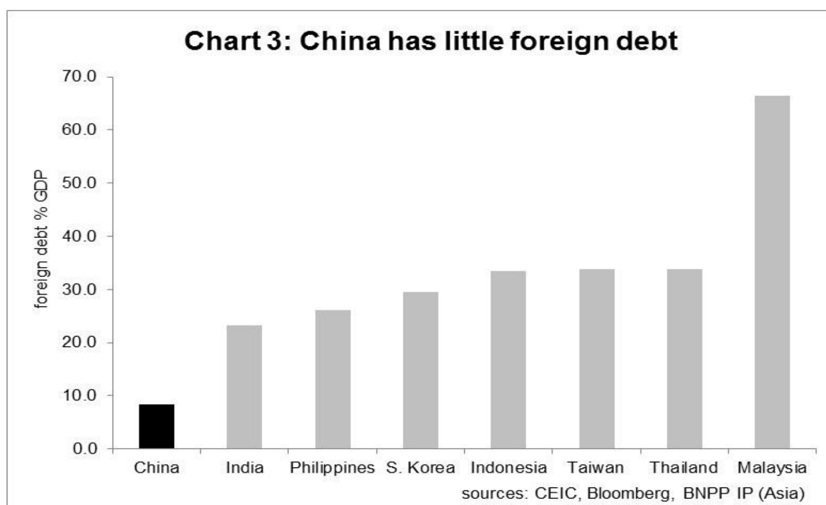
To remedy an external account crisis, the country concerned usually has to devalue its currency and restructure its foreign debt. With a banking crisis, the remedy typically involves recapitalizing the country's domestic banks to contain systemic panic. As China has neither a fully convertible capital account nor a fully floating exchange rate, such a closed system reduces the likelihood of a full-blown financial crisis in its economy.

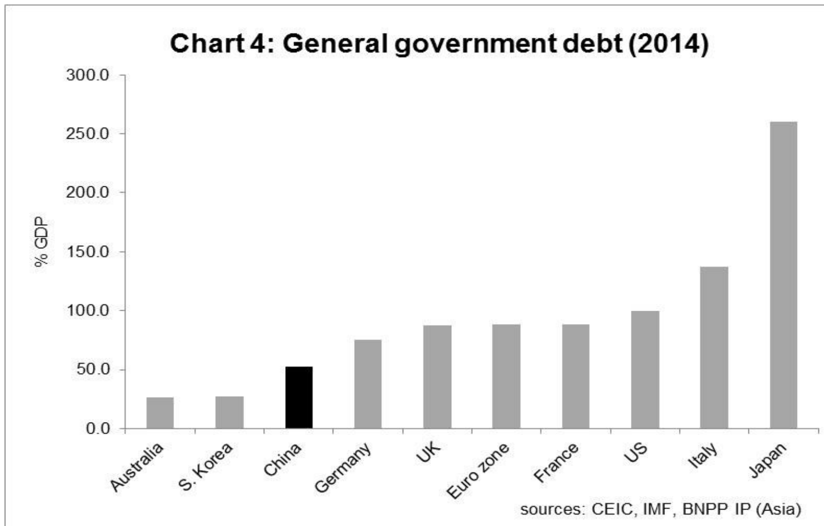
Clearly, China does not face an external account crisis. Its basic surplus (i.e. current account balance plus net foreign direct investment inflows) amounts to 4% of GDP and its foreign exchange reserves amount to more than 40% of GDP (Charts 1 and 2). These levels are enough to cover more than two years of imports (compared to the safety norm of three months-worth of imports). Its short-term foreign debt is only 8% of

GDP (Chart 3), despite its rapid accumulation in recent years; total (local and central) government debt is just 52.8% of GDP (Chart 4), which is below the danger threshold of 60%.

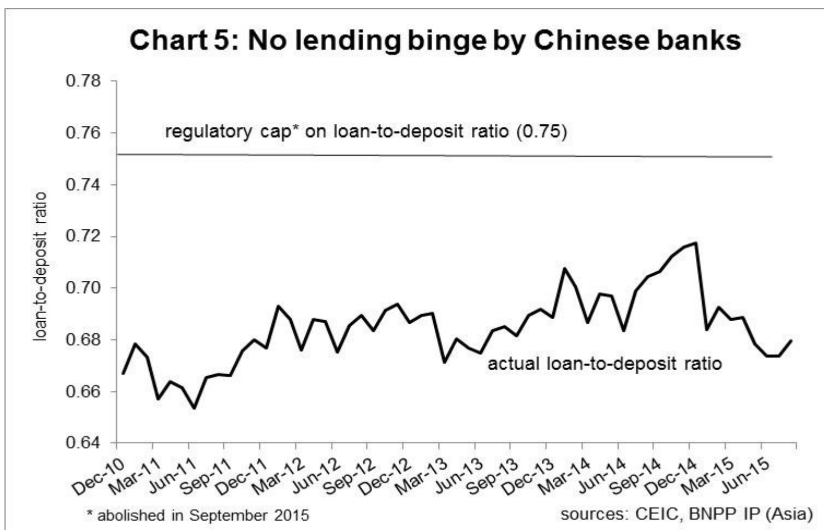


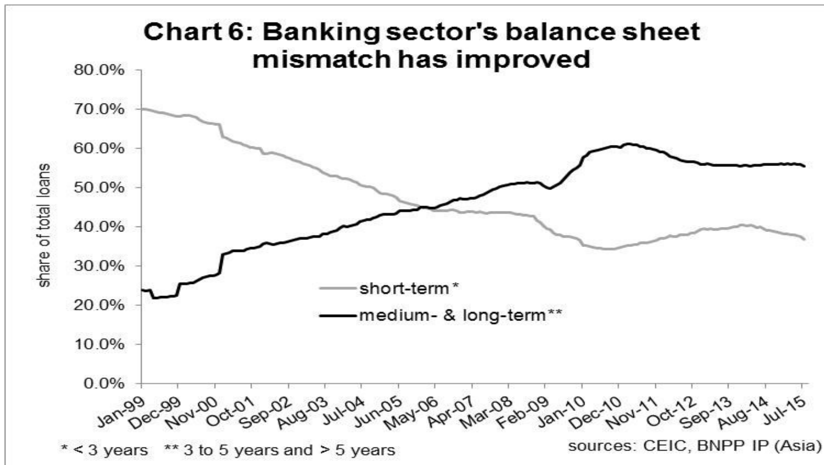


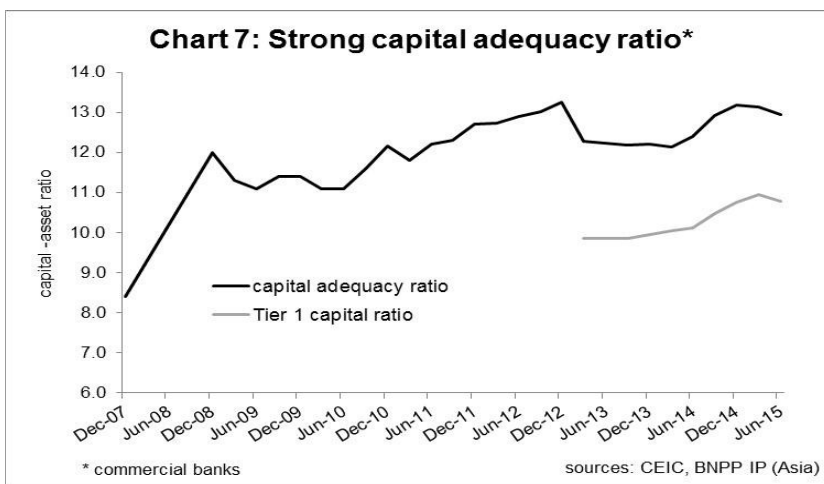


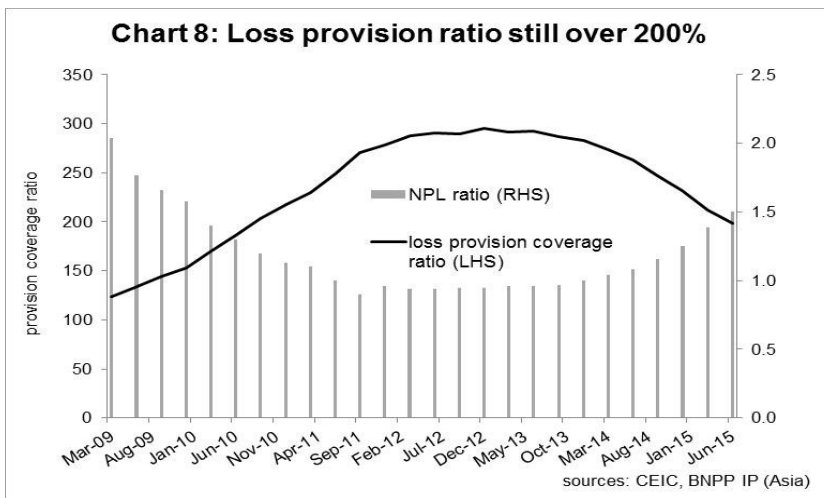


So rather than an external account crisis, market fears have centred on the risk of China suffering a banking crisis. But evidence shows that such a risk is within manageable limits. China's asset bubble has not been funded by excessive bank lending, as seen by the loan-to-deposit ratio remaining well below the 0.75 regulatory cap (Chart 5) when the property and stock market bubbles were inflated. The banking sector's balance sheet mismatch has improved in recent years (Chart 6), and its average capital adequacy ratio is high at over 10% (Chart 7). The system's average loan-loss provision remains at 200% of bad assets, despite some drop-off from a peak of 300% and rising non-performing loans (Chart 8).









Meanwhile, China's property market correction has not seen a collapse in property prices (Chart 9) like that in the US property bust in 2007-08 which caused undue financial stress in the banking system. This may likely be a result of a lack of excessive leverage in China's property bubble and the government's implicit guarantee policy, which is designed to prevent a loss in public confidence in the banks.

So any perceived China crisis seems to be stemming from the fear of capital flight by local Chinese. In our view, this is unlikely because China's capital account is still relatively closed, and most Chinese investors can still get a 5%-6% yield on local wealth management products. They would also have to pay 3%-4% for currency conversion charges to take money out of the country. The trade would be worthwhile only if they expect the renminbi to fall by more than 10%, which we believe is unlikely[1].

Rather than a financial and economic meltdown, China is seeing an overdue correction in its asset market. Beijing did intervene heavily in the stock market initially, but retreated after about two weeks. Allowing the correction to take place is part of the process of China further opening up its financial system to market forces. The recent sell-off of Chinese assets reflects the frictions from economic rebalancing and liberalisation, rather than being based on the fundamentals of the Chinese economy.

In the coming months if Beijing manages to keep the renminbi stable, if China's economy starts to stabilise, and if the renminbi is admitted to the International Monetary Fund's Special Drawing Rights basket, the market will have to admit that China's economic growth had not crashed, thanks to a stabilising property market and the continued expansion of the service sector that has kept wages, job and consumption growth stable.

Those who have sold China short may then wonder why they were involved in a negative carry-trade based on fundamentals that are not as bad as they anticipated and expected catalysts that never materialised. When they start covering their short positions at a time when the renminbi is under-owned and when China runs the largest trade surplus in the world, Chinese asset prices and the renminbi exchange rate will have to rise.

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[1] See *"Chi Time: How Serious is China's Capital Flight?"* 4 March 2015, and *"Chi on China: The Tide of the Renminbi is Turning",* 23 September 2015.

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