What is the risk of a financial crisis in China?

Not a meltdown, but a slow puncture

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Overview

- Slower growth, combined with rising stress in property sector, deflationary pressures, and increased policy uncertainty have again raised the question of whether China is at risk of financial crisis
- Key aspects of China's financial system make a crisis along the lines of the 2008 GFC extremely unlikely
- But there are pressure points in the system - primarily the regional banks - which may not be systemic but which will be costly to resolve
- Overall, the most likely outcome is a period of (much) slower growth and a less efficient financial system

Background

Pressures on China's financial system are growing

- Policy pivot - move away from old growth model (and lower growth targets), emphasis on state-led development of new high tech industries
- Property market correction - ripples spread beyond Country Garden and Evergrande to broader economy
- Subdued post-Covid recovery - weak consumer sentiment
- Stress in shadow banking sector (Zhongzhi)
- Pressure on local government finances/LGFVs

Policy Pivot

Less predictable policy

- Underpinning slower growth is reduced policy predictability
- Adam Posen's "economic long covid" - sudden switches in policy, not just ending of zero covid policy, but crackdown on internet platforms and online tutorial industry. Undermines confidence, both in private sector and in consumers
- Clear pivot of policy towards prioritising certain industries - such as semiconductors and EVs - relying on a state-led development model
- But even if this strategy is successful, unlikely that these new industries will be sufficiently large to compensate for the decline in the contribution to GDP growth from the property sector

Property sector correction

- Deliberate government policy to reduce role of property in GDP growth
- Introduction of “3 Red Lines” policy in 2020 signalled intention to rein in leverage in the sector
- Household sector leverage has also increased rapidly, to levels equivalent to some developed economies, albeit at lower income levels
- Contribution of property sector to GDP usually estimated in range of 25-30%, but often exaggerated as includes upstream and downstream industries
- Prior to recent correction, sector had been in managed decline (to around 21% of GDP), but ending of zero covid policy turned this into a rout
- Exposure of financial sector to property (lending to developers plus mortgages) estimated by KPMG at around RMB53 trillion (USD 7.3 trillion)

Local Government Financing Vehicles

Collateral damage from property downturn

- Local governments carried responsibility for implementing infrastructure investment during the post-GFC stimulus, and for driving forward urbanisation projects
- But often lacked the financial resources to do so
- Solution: establish off-balance sheet vehicles (basically a form of local government owned SOE) to borrow from the banking system
- Repayment capacity provided by future land sales to property developers
- Property market correction has led to severe decline in repayment capacity

Could China face its “Lehman moment”?

Or a “Minsky moment”?

- Shorthand to describe the situation in 2008 when:
  - Risk aversion dominated
  - Liquidity evaporated from key funding markets
  - Soundness of even “too big to fail” FIs began to be questioned
- A “systemic” crisis is one in which financial system instability leads to real economic effects through disruption to the payments system and credit intermediation
- Some commentators have drawn parallels with China now - but they neglect the important differences between China’s financial system and those of the West.

What makes China's financial system different?

Important contrasts with West's market based system

- System remains predominately state owned/controlled
- State plays an active role in directing credit
- Capital account remains tightly controlled
- State controls multiple balance sheets that could be used to absorb losses (beyond equity of the state owned banks)

Consequences

A full-blown financial meltdown is unlikely

- Liquidity could be recycled
- Overall system liquidity unlikely to be negatively impacted by capital flight
- Even large bad debt write-offs would not seriously impair the ability of the system to continue to provide payments services and credit intermediation, as authorities have multiple options:
  - Recapitalise
  - Distribute losses
  - Practice forbearance
- Evidence of other countries is that even seriously decapitalised banking systems can continue to function if capital account remains closed

But significant risks exist

…even if they do not rise to the level of systemic problems

- Regional banks are a potential pressure point - combined balance sheet of City Commercial Banks approx. USD 6.5 trillion in 2020 (approx 2x balance sheet of JP Morgan Chase)
- Local government owned regional banks have extensive exposures to their owner local governments, local government owned SOEs, property developers and LGFVs
- Deeply interconnected system depending on uninterrupted flow of development projects, land sales, local government revenues and consumer demand for new apartments
- Like a bicycle - only stable as long it as remains in forward motion

Risks from regional banks

Could be costly to resolve for central government

- Despite some interconnection between regional and “Big 4” banks (the latter have been net lenders to the former), the potential for smaller banks to destabilise the system remains low
- But there could be substantial bail-out/resolution costs if losses in the regional banks grow
- Would need to be borne by central government as local governments lack resources for a bailout - would increase pressure on central government budget (Moody’s negative outlook)
- For comparison, the S&L problems in the mid-1980s of the US cost around USD160 billion (in 1980s $) to resolve - equivalent to 3% of GDP

What about shadow banks?

Risks have subsided, although pockets remain

- Shadow banking sector in China covers a very broad range of entities/activities, including trust companies, entrusted loans, acceptances, fintech, money market funds. De facto financial sector liberalisation

- "Regulatory windstorm" unleashed in 2017 has significantly reduced the size - and risks - of this sector. Shrank rapidly from the equivalent of 87% of GDP in 2017, to 39% in 2023.

- Focus on reducing interconnectedness of shadow banks and the formal banking sector (largely successful)

- But pockets of risk remain - especially exposure of trust companies to property sector - also concentrated in certain provinces (often the same ones at risk from regional banks)

Declining policy effectiveness

A bigger problem than the immediate risk of financial crisis

- Reduced policy predictability has contributed to this risk
- Qiushi article in late 2023 clearly stated that financial sector must be subject to Party's policy priorities and central direction
- Monetary policy effectiveness is also declining
  - Signs China may have entered a classic liquidity trap
  - Corporate credit costs declined by record amount in Q1 2023, but no corresponding pick up in loan demand - pattern repeated throughout last year
- Japan-ification?

Conclusion

- No financial crisis, but….
- Slower growth is inevitable on current policy settings, with the government's contingent liabilities (including those arising from banking sector) more likely to crystallise
- Interconnection between regional banks, LGFVs & property developers could require a central government bailout, which would be costly
- Financial system will become less efficient and more politically directed in future
- A "Japan-style" scenario of high levels of indebtedness and low growth looks increasing likely