Mitch Hayes September 24, 2018

What would cause a financial crisis in China, and how would it manifest itself in the absence of foreign denominated debt, open capital accounts and a convertible currency?

A financial crisis "with Chinese characteristics"

In the midst of the 2008 financial crisis, China launched an enormous economic stimulus package to counter collapsing global economic growth, sustained by a rapid growth in debt. It was spared the worst of the crisis, insulated from capital outflows and currency gyrations thanks to the economy's unique characteristics of minimal foreign denominated debt, closed capital accounts and limited currency convertibility. However, these features, combined with a political dependence on debt-driven growth now pose its greatest risk of a domestically derived financial crisis "with Chinese characteristics."

Despite widespread concern over China's surging debt levels[1], the consensus view trusts the state's financial capacity and political willingness to implore banks to roll over bad debt, restructure loans, and offer lenient terms. However, the risk of a crisis remains, and just as China's state-centric "authoritarian capitalism" provides it with unique capabilities for market intervention, these characteristics have also seen China's financial markets grow dangerously in size, complexity and opacity in recent years.

If a financial crisis was to occur in China today, it would start in its poorest north-eastern provinces, transmitting through the balance sheet of its abundant smaller provincial banks. These banks have highly concentrated exposures by geography and industry, a large portfolio of non-traditional loans disguised on their balance sheets as alternative assets, and a heavy reliance on wholesale markets to fill the funding gap from their high loan to deposit ratio.

Triggers for such a crisis would likely come via a regulatory miscalculation that tightens credit conditions too quickly on small banks, sparking an interest rate shock for private sector refinancing, a loss in market confidence, and contagion through the interbank lending market. The opposite regulatory misjudgement is also feasible, where an ongoing trade war prompts renewed credit expansion to a distressed export-driven private sector, followed by subsequent tightening.

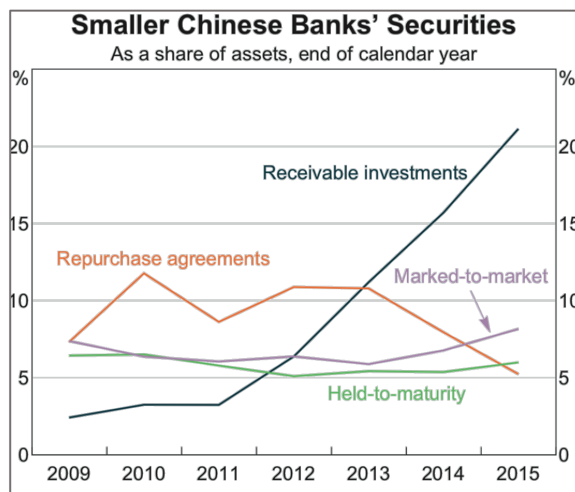
China's small and medium banks have grown rapidly to occupy more than 50% of total banking assets in recent years[2]. These banks often stump for loss-making SOEs under the assumption of a government guarantee, while pursuing private borrowers and a growing consumer credit market.

In recent years, these banks have aggressively expanded their lending portfolio to chase dwindling profits amidst slowing economic growth, quickly reaching the PBC's lending limits. To circumvent these limits, small banks have begun disguising loans as "investment receivables" - asset backed securities originated by non-bank lenders and purchased by

[1] For example, see "IMF warns China over 'dangerous' levels of debt" (https://www.ft.com/content/4ca05a5a-81a3-11e7-a4ce-15b2513cb3ff)

[2] See RBA. 2016. "Recent growth of small and medium sized Chinese banks." *Financial Stability Review*, October: 14-16.

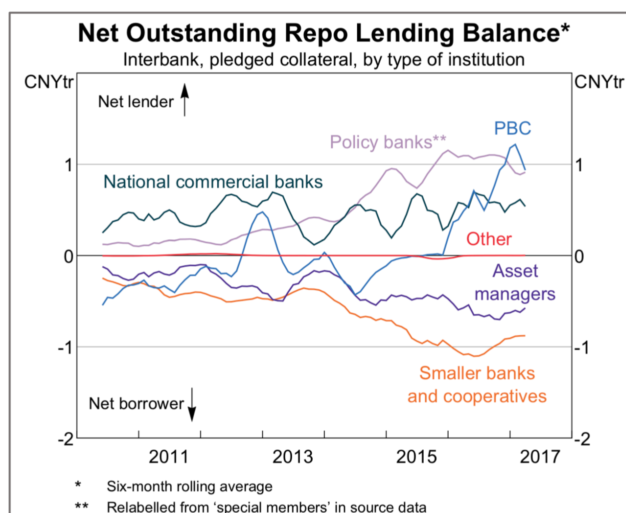
partnering banks. These securities account for one third of total assets in some of these small banks[3].



Source: RBA. 2016. "Recent growth of small and medium sized Chinese banks." Financial Stability Review, October: 14-16.

The growing funding gap has been met through repurchase agreements ("repos") in the interbank lending market. Repos are a widely used short term collateralised loan, utilised by banks globally. The collapse of the US repo market was a key reason why California and Florida's subprime crisis metastasized into a banking crisis in 2008.

By far the largest borrowers in the Chinese repo markets are small regional banks and non-bank lenders. Lending to them are large commercial banks, policy banks, and since 2015, the PBC. The market has grown rapidly in the last three years, totalling US $720bn in outstanding loans in 2017, one third the size of the US repo market.



Source: Kendall, Ross, and Jonathan Lees. 2017. "The Chinese Interbank Repo Market." Reserve Bank of Australia Bulletin, June: 75-86.

Even more alarmingly however, is the existence of an interlinked, informal, unregulated repo market known as "*dai chi*". It is estimated by Chinese officials to be as large as US $1.7tn, more than twice the size of the formal repo market. Believed to be used by the same borrowers of the conventional repo market, *dai chi* is thriving for its utility in letting banks flout macroprudential requirements. There is little information on the collateral's quality, the legality or the enforceability of these trades, however analysts assume it to be a far riskier market[4].

Deterioration in the perceived credit-worthiness of these regional banks could quickly freeze them out of repo markets through increased interest rates and higher collateral calls. Failure to meet these demands would impact the net creditors in these repo markets, China's largest commercial banks and policy banks, a nightmare scenario for the PBC, and represent the realisation of a financial crisis.

Of course, the assumption is that the PBC will insert itself as a market-maker, ensuring a repo liquidity crisis won't freeze the entire market and presage a broader economic downturn. This commitment was demonstrated by the PBC in 2016, when it mandated China's largest

[3] Ibid.

[4] See Kendall, Ross, and Jonathan Lees. 2017. "The Chinese Interbank Repo Market." *Reserve Bank of Australia Bulletin*, June: 75-86.

repo lenders to maintain an active market after fears of fraudulent trades in the *dai chi* market spread to the formal repo market, widening interest spreads for non-bank lenders, and prompting a surge in bond prices.

A much larger deterioration in asset quality would place greater pressure on the PBC to maintain this market, contingent on its reserves. However, the unique nature of China's political and economic system becomes apparent in its limitations in stemming a broader financial crisis. In the absence of raising foreign denominated debt, the PBC would be constrained to its existing local and foreign currency reserves. The latter is likely to be diminished should the trade war with the US continue.

As news of a crisis infiltrates markets, pressure would build for renminbi devaluation. Absent currency convertibility however, the value of the renminbi would become overvalued, further harming its export industries, and hurting its terms of trade. In echoes of China's 2008 response, slow acting fiscal options would be sidelined in favour of broad monetary stimulus. Stimulus would likely provoke higher inflation, plotting an unsustainable path towards political instability via a slowing economy and higher cost of living.

Ultimately, China would be faced with a choice - to pursue domestic financial and political stability, under the building tension of currency inconvertibility, tight capital accounts, and an unwillingness to raise foreign denominated debt. Or, they attempt for a middle ground, managing an economic contraction, risking internal political revolt. In either scenario, the political and economic choices facing Xi Jinping are intertwined. A "financial crisis with Chinese characteristics" would be tumultuous, with its political resolution potentially more consequential than the 2008 financial crisis was for the US.