

Will Wall Street's Woes Cause A Chinese Financial Crisis?

Everyone should plan for potential spillover from global turmoil

By Michael Pettis



Over the last several weeks and months, the international economy has been put on edge as major US firms in the financial industry have gone belly-up, been bought out by competitors or been bailed out by the government. Given the scope of the crisis, many have wondered if the current American difficulties could spread to China on a similar scale. The most important factors to consider when assessing China's susceptibility to a financial crisis are the country's underlying fundamentals, most specifically its monetary policy and domestic balance sheets.

Financial crises occur when govern-

ments, corporations or, most importantly, financial institutions have built unstable balance sheets that suddenly break down under the pressure of a major shock. Historically, these calamities have always been preceded by extended periods of excessive growth in underlying liquidity. In these scenarios, financial institutions have overextended themselves, adjusting to excessive liquidity by building up increasingly risky balance sheets. They have taken on precarious practices to accommodate overly enthusiastic borrowers and lenders.

In the early stages of these liquidity surges, the economic results are almost always positive. Increasing risk tolerance and the easy availability of

money cause a boom in asset markets, with riskier markets performing especially well. In highly developed financial markets, if liquidity remains ample, high prices and narrow spreads encourage investors to take on increasingly risky behavior. This typically involves increasing leverage, shorting liquidity, mismatching assets and liabilities (currency mismatches were especially common during the 1994 and 1997-98 crises), or implicitly selling options on volatility through structured transactions. In less developed financial markets, increase in risk also occurs, although often in different ways. Loan growth can accelerate sharply, credit oversight weakens, loans are likely to be highly concentrated in "hot" areas

like real estate and profitable lending to speculative borrowers is likely to increase.

In either case, balance sheets become increasingly vulnerable to systematic shocks. The type of financial system or regulatory framework matters much less than we traditionally think. For example, in the past two decades, the two major exponents of the main opposing financial system models have both experienced crises. The two financial systems are the so-called Anglo-Saxon model of free and unregulated financial markets (of which the US is the prime example) and the bank-dominated, highly regulated model typical of countries like Japan in the 1980s.

Both the current US crisis and Japan's in the 1990s were preceded by several years of runaway monetary growth. This was the underlying condition that allowed for problems relating to complex derivatives, sub-prime mortgages, too-little regulatory oversight and skewed compensation incentives in the US, and similar issues with real estate and stock market bubbles, excessive regulation, and too-close links between banks and corporations in Japan. The excess monetary expansion in both run-ups made risky balance sheets almost inevitable. The only question was how the ultimate adjustment would manifest itself.

All of this brings us back to the current economic situation in China. Much of the debate about how tight or loose Chinese monetary policy should be begins with two faulty implicit assumptions. The first is that the People's Bank of China (PBoC) can effectively control domestic monetary conditions. The second is that it can control the expansion of the domestic banking system.

When a country has open capital markets, its central bank must choose between controlling the foreign exchange value of its currency and the amount of money in circulation. It cannot do both. While China technically does not have open capital markets, its controls are so porous that in reality policymakers cannot

control these two areas. If they target the exchange value of the *Renminbi*, the PBoC must buy or sell appropriate foreign exchange to maintain the target level. As importantly, in order to fund the purchases the PBoC must issue or withdraw money (or central bank bills, which are a very close substitute for money).

China's high savings rate and rapid growth in industrial production has meant that the country runs a trade surplus. Additionally, net inflows on the trade account have been augmented by additional net inflows on the capital account as investors buy Chinese as-

the rate of loan growth, but there, too, it has much less control than is commonly thought. This is because China has a monetary policy that encourages massive credit expansion, with central bank regulators nonetheless trying to impose restrictions on loan growth. The end result in a situation like this tends to be the creation of one or more parallel financial systems with a forced impetus for loan expansion.

This forced loan expansion seems to have occurred in China. The PBoC purchases of foreign exchange accelerated in 2007 and 2008. Meanwhile, lending constraints were enforced on

the banks. One consequence of this was an explosion in off-balance sheet lending and the financing of activity by underground and informal banks. Rather than constrain credit growth, the PBoC's lending caps may have done little more than to shift loan growth out of the banking system and into riskier

and more opaque sections of the economy.

The net result is that China may have the pre-conditions for a sharp and difficult financial adjustment. China has experienced massive monetary growth. Its financial system—at least to the extent that it is transparent—has seen loans grow rapidly, and anecdotal evidence gives little comfort that this growth has been prudent or under strict credit controls. In fact, China seems to be displaying all of the excesses associated with disproportionate monetary growth.

It is, by definition, difficult to predict shocks, but there are two obvious channels by which the global difficulties could precipitate a Chinese crisis. The first is through its impact on the real economy. If global growth slows, it could bring with it a sharp decline in Chinese export growth. Domestic consumer demand may be unable to pick up the slack, especially as declining real estate and stock markets coupled with scary newspaper headlines could dampen consumer confidence. In this scenario, Chinese companies, which have borrowed and expanded production facilities at an enormous pace in

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sets to take advantage of low prices and expected growth. That leaves the PBoC in the position of being a permanent buyer of foreign currency. The result of all of this is that domestic monetary expansion is solely driven by its need to purchase US dollars.

When China creates money in this way, it has nothing to do with the perceived monetary needs of the economy. Instead it has everything to do with the expanding surplus on the country's balance of payments. Since this surplus is so large, and has been so since at least 2004, the PBoC creates far more money than the Chinese economy needs. In 2006, for example, foreign reserves grew by US \$247 billion, a further \$462 billion in 2007, and an astonishing \$281 billion just in the first half of 2008.

China's currency regime has been forced into expanding its money supply very quickly. However, too much money has caused a number of domestic imbalances. Chief among them is excessive loan growth in the country's shaky banking system and over-investment in fixed assets. In its function as regulator of the banking system, the PBoC has tried to control

recent years, may find it very difficult to generate the revenues needed to maintain debt payments. If non-performing loans (NPLs) rise and force banks into contracting their activities, or if rising inventories cause companies to cut production and investment, the banking system might find itself in a spiral of rising NPLs and declining asset prices.

The second channel involves changing risk perceptions. In recent years, China has been the recipient of a great deal of speculative capital seeking to take advantage of its rising currency and expected growth rates. However, if either expected returns decline or, more worryingly, if risk expectations rise dramatically (or both), investors who brought money into the country may decide to withdraw it just as rapidly. The just-released PBoC reserve numbers suggest that China may have seen its first month of hot money outflows in September.

Most analysts who focus on the risk of speculative outflows dismiss the problem by arguing that given China's reserve levels there is little chance of an attack on the currency that leads to the sort of crises experienced by Asian neighbors in 1997. Yet that argument, while correct, misses a critical distinction. The danger China faces with speculative outflows is not that of a collapse in its currency, as was the case in countries like Thailand a decade ago. The real danger is that fleeing capital is likely to be withdrawn either from the banking system, putting liquidity pressure on the banks, or after the sale of assets, putting more downward pressure on asset prices.

The past two years has seen the global crisis develop rapidly and in unexpected ways. Although it has been hard to predict linear extensions of the crisis, it seems clear that there are underlying causes for which to look. Specifically, systems characterized by rapid monetary growth and overextended financial systems have been brought into the storm one after another. We will not know until after the fact how shaky China's financial system has become in recent years, but recent events should make bankers cautious.

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First-Rate Talent in Second-Tier Cities

Companies need a strong HR strategy to succeed in China's provinces

By Gregory P. Gilligan



AmCham-China members on a recent provincial trip to Hubei

The push among many businesses in China is to move beyond the traditional economic bases of the Pearl and Yangtze river deltas in the coastal areas is well underway. These advances have increased pressure on the labor market's capabilities and have been accompa-

nied by increases in competition for quality workers. It costs more and more to get the right talent and can be difficult for companies to keep the best workers. Projected year-on-year wage percentage increases for the near future at many large multinational companies are in the mid-teens. Adding in social cost (mandatory benefit)

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