China’s Financial Instability and Recent Turbulence

Whitman Lecture

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The topics of China’s financial instability and possible triggers of a financial crisis over the years

- **In 2012**
  - China’s housing market is on the brink of collapse.
  - China’s fiscal position will worsen rapidly because of massive local government debt.
  - The crash of underground credit networks will lead to a broad financial crisis across the county.

- **In 2013**
  - Shadow banking activities
  - LGFV
  - Corporation debt
  - Property bubble

  - Shadow banking activities attract greatest attention


- **In 2014**
  - Shadow banking activities
  - LGFV
  - Corporation debt
  - Property bubble

  - High financing costs and unavailability of credits to small enterprises

- **In 2015**
  - Stock exchanges crash
  - RMB exchange rate depreciation

  - No more discussion of property bubble

  - Less attention given to shadow banking activities
Three important topics

• Corporate debt
• Stock price bubble
• Exchange rate
The rise in China’s corporate debt-to-GDP ratio imposes most serious threat to China’s financial stability in medium and long term.
China’s corporate leverage

• Since the Global Financial Crisis broke out in 2008, China’s nonfinancial corporate debt has been rising steadily and rapidly.
• According to Standard & Poor's, corporate debt $16.1 trillion (2014), 160% of GDP
• According to CASS, 145% of GDP
• Will China’s corporate debt-to-GDP ratio continue to rise until it blows up?
The corporate debt-to-GDP ratio is rising steadily: worrying? But...

Portions including foreign banks' claims

Source: Haver.

IMF working paper
What will be the trajectory of China’s Corporate debt in the future?

Corporate investment financed by enterprise profits, new debts and POs. That is:

$$\frac{dD}{dt} = I - X - \Omega$$

Where $D =$ debt balance, $I =$ corporate investment, $X =$ corporate equity finance, $\Omega =$ corporate profits after payment of interests, which will be kept by corporates to finance investment.
The dynamics of Corporate debt-to-GDP ratio

\[
\frac{d\beta}{dt} = vn - q - \omega + (r - n - \rho)\beta
\]

determine the trajectory of $\beta$-corporate leverage ratio
What are the trajectories of those factors that determine the trajectory of China’s corporate leverage until 2030

• Capital efficiency
  – low and falling (capital-output ratio rising)

• Corporate profitability
  – has been falling steadily

• share of finance via capital market
  – Very low

• interest rate on loans
  – High

• Inflation rate
  – producer price Index is falling

• growth target
  – Relatively high
Trajectory of the capital-output ratio
Why capital-output is so high and rising
Trajectory of corporate profitability (before interest payments)
Equity finance to GDP ratio (cannot be predicted)
So far nominal interest rate resists to fall (difficult to predict)
In 2020, the ratio will surpass 200%!!
The stock market turbulence

China’s stock price fiasco: “to save the city, we bombed the city”

The implication on China’s financial stability is limited

But it bring authorities’ ability of crisis managing into question

Indirect implication is serious
The rise and fall of stock exchanges

Unsteady beat

China

GDP

% increase on a year earlier

Shanghai stock exchange composite index
December 19th 1990=100

Sources: Haver Analytics; Bloomberg

Economist.com
Three stages

  - Shanghai Stock Exchange Composite Index (SSECI)= 2505,
  - Fell to 3166, by 300 points and 7.7%
  - China Securities Regulatory Commission (CSRC); clamped down on “Liang Rong”—margin financing (MF), stock collateralized lending (SCL)
  - SSECI peaked at 5178.19 on 12 Jun.
  - It increased by more than 100% in less than 7 months
- Stage 3 (Jun. 15, 2015-present)
  - On 15 Jun. SSECI fell to 5062.99, by 103 and 2% over the previous day. This was the day when the bubble started to burst
  - Now the index fluctuated violently, threat to break the threshold of 3000 point
How was the bubble created?

• Government policy objectives
  – To enable debt-ridden corporates to get funds from the equity market
  – To boost share prices to stimulate demand via wealth effect
Measures taken to boost share prices

• margin trading was encouraged and facilitated

• Monetary loosening (lowering the RRR and benchmark interest rates etc.)

• Reform of IPO procedure: from the examination and approval system to the registration system

• Shanghai-Hong Kong connection

• Expand quotas of QFII
The seven channels mentioned above are margin financing (MF), stock collateralized lending (SCL), umbrella trust (UT), stock benefits swap (SBS), structured mutual fund (SMF), P2P and offline private fund matching.
The crash

• the China Securities Regulatory Commission decided to restrict offline private fund matching in the middle of June.

• On 15 Jun. The SSECI fell to 5062.99, by 103 points and 2% over the previous day

• Because the wide use of margin trading, the fall in stock prices led to margin call, a correction turned into a collapse
The government rescue

- when stock price index fell to 4200, CSRC usher in rescue package includes
  - stopping IPO
  - discourage shorting
  - organizing a “national team” to prop up stock prices
  - Changing the rules of game

- The hope for reducing corporate leverage via the capital market is dashed.
Where did money come from

• High growth of bank credit, due to the PBOC’s rather loosened monetary policy since the global financial crisis.
• Low corporate profitability, clamp down on real estate investment and on shadow banking activities
• In 2014, money flew into the share market, which was in a bad shape and share prices were still low
• Two bubbles have burst, what next?
Exchange rater reform or devaluation?

• August 11 “reform”—Things happened rather suddenly
• The episode rekindle an old problem that has been debated since 2003
• The implication of episode can be more serious than the stock market fiasco, with much large international consequences
• The failure will have serious consequences on China’s financial stability
August 11 announcement and devaluation

The daily fix and the closing price on previous day

Lower daily fix by 1.9%

Closing price

Daily fix on 12 Aug

Aug-17
Unexpected fall?

看起来没有真正想转向浮动汇率。
Where does depreciation pressure come from? China has been running capital account deficit since the second quarter of 2014.

In the first quarter of 2015 China’s capital account deficit is larger that than that of current account surplus.
Causes of capital account deficit

• The Unwinding of Carry trade
• The diversification of financial assets by households
• Outbound foreign investment
• Capital flight
• In short, the currency structure of China’s international assets and liabilities are undergoing adjustment
How much ammunition China still have
Should China continue to defend the RMB

• What exchange rate regime China wish to have?
  – Carry though the 11 August reform
  – Floating
  – Quasi-Peg to USD
  – Peg to a basket of currencies

• My view is that China should stop intervention and let the RMB to float.
If China stops intervention, what will happen?

• Devaluation? Yes, but how large?
  – Now one knows. But should not very large. 10%? 20%?
  – China is still running current account surplus
  – China still has capital control

• What will be the negative impacts of a large devaluation
  – Banks currency mismatch, if there is large borrowing in foreign currency by banks.
  – Inflation
  – Corporate debt, if there is large borrowing in foreign currency by corporates
  – Sovereign debt, if there is large borrowing in foreign currency by the governments

• For China
  – Corporate foreign debt: According to BIS, 962 billion USD, 70% without hedging. China’s own figure is much smaller, less than 500 billion USD
  – Banks foreign debt: 300 billion USD, peanuts
  – International condemnation: currency war
  – What else?
The significance of the RMB exchange rate reform

- Over the past two decades, the single most important market distortion is exchange rate distortion. The reform of exchange rate regime has been delayed for too long.
- Without a flexible exchange rate, China will not be able to implement independent monetary policy without distortion.
- Slow appreciation and slow depreciation encourage carry trade and shorting. In both directions, China suffers welfare losses.
- Without making exchange rate flexible first, capital account liberalization will become a dangerous adventure.
- Without a flexible exchange rate, RMB internationalization will not go very far. As soon as carry trade becomes unprofitable and shorting becomes a favorable game, de-RMB internationalization will begin.
- A flexible exchange rate will give great impetus to China’s economic readjustment and growth paradigm shift.
Concluding remarks

• There will more turbulences to come
• Like in the past, China probably will muddle through again