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#virus #chinadebt

Thinking Macro

China financial systemic risks: Why 2020 is not 2015

- As the economic effects of the COVID-19 virus start to show up in data, investors have begun asking about a possible repeat of 2015, when heavy capital flight from China and a precipitous fall in the country's FX reserves (amid a decade-long increase in debt) roiled markets.
- We believe that conditions are different this time. A repeat of the China-related financial market volatility of 2015 seems unlikely in 2020, and related financial systemic risks have decreased appreciably in the past five years. This is not because of a bullish view on China growth; we have reduced our full-year GDP estimate to 5.4%, with risks skewed to the downside.
- We also acknowledge that in some ways, China is less prepared now for a resumption of capital flight. Its FX reserves are smaller, even though the domestic financial system is considerably larger, it no longer runs a large current account surplus, and the country's debt profile has not improved materially in the past five years. And yet, in our view, several factors that sparked the year-long capital flight of 2015 are currently missing.
- For one, Chinese authorities put in place a series of measures to control capital outflows after the 2015 experience, including tightening approvals for cross-border acquisitions, monitoring overseas spending, increasing disclosure requirements, and strictly enforcing penalties for currency infractions.
- In addition, the USD experienced a 12-15% (trade-weighted) run-up from 2014 to 2016 in anticipation of Fed hikes, at a time when the CFETS RMB index did not exist and markets believed in an implicit peg to the USD. We do not expect USD strength of that magnitude this year, with the Fed firmly on hold. Moreover, China showed in 2019 that it could manage a significant depreciation (with USDCNY moving past the decade-long 7 level) without a material change in its FX reserves.
- Importantly, Chinese authorities engineered a significant increase in domestic liquidity in 2015-16 in an effort to support growth, with M1 growth rising from 3% in 2014 to 25% in 2016. In our view, this excess liquidity contributed materially to capital flight. China has been far more measured this time, with money supply stable in recent years and running at just 4% currently.
- Finally, China has also made strides in attracting capital inflows in recent years. The inclusion of Chinese bonds in major benchmark bond indices, as well as the sharp increase in the weight of China A shares in the MSCI index, points to steady passive inflows to China's financial markets.
- We would need to see months of sustained capital flight, along with a corresponding decline of hundreds of billions of dollars in China's FX reserves, before we start to worry about a repeat of 2015. The conditions for that to occur, we believe, are simply not in place any more.

Ajay Rajadhyaksha*
+1 212 412 7669
ajay.rajadhyaksha@barclays.com
BCI, US

Jian Chang*
+852 2903 2654
jian.chang@barclays.com
Barclays Bank, Hong Kong

www.barclays.com

The COVID-19 virus has dominated financial headlines over the past several weeks. Analysts – ourselves included – have rapidly taken down full-year GDP forecasts for China[1] and, thereby, for global growth. Oil is in a bear market, core bond yields have rallied sharply, and the RMB has depreciated from its strongest levels in mid-January. And sure enough, like clockwork, the "big" question about China has started to come back. Is this it? With China growth now likely to slow to its lowest levels of the past three decades, is this the tipping point at which China's debt bubble bursts? Could this be a repeat of late 2015 and early 2016, when it seemed as if China's struggle to stem capital flight[1] would lead to a sharp, violent adjustment in its currency, an event that would have carried significant repercussions not just for China but also for global financial markets?

The short answer is no. The financial systemic risks posed by China are now significantly lower than in 2015, despite the growth challenges. Our view is not a function of being bullish on China growth. In fact, we just lowered our 2020 GDP forecast to 5.4% (full-year growth) from 5.8%, and our growth concerns about China are still largely to the downside. Rather, we emphasize that several other factors were behind the events of 2015 and early 2016, and they are missing now.

Why the world worries about China…

The rapid increase in net and gross leverage in the Chinese economy over the past decade is well known, and we will not go into the details here. Suffice it to say that high-profile investors, multinational institutions, regulators, and rating agencies have all warned for years about the dangers posed by rising levels of China debt. For example, the IMF has repeatedly urged China to halt credit-fuelled growth and warned about "dangerous" levels of debt and the risk of a "disruptive adjustment."[2,3] Moody's warned last December that Chinese corporate debt was the "biggest threat" to the global economy.[4] Even the PBoC warned of financial risks to the Chinese economy, highlighting the rapid increase in both household leverage and borrowing by local government vehicles and the corporate sector.[5]

There is an assumption implicit in all these warnings – that aggressive and sustained credit growth has created a debt bubble that could burst painfully. After all, when credit expands at the pace that China has seen over the past decade, it often leads to asset misallocation, especially if much of that credit is "directed" in a centrally planned economy. Such policies can lead to excess manufacturing capacity in a wide variety of industries, giant malls with not enough customers,[6] fifty million empty apartments across the country,[7] etc. And often, the build-up of these unproductive assets ends badly.

There is one saving grace. Most of the debt build-up in China has been financed by local savings and is in local currency. In other words, China does not face the usual sort of emerging market crisis, which typically occurs when a country has large amounts of liabilities in dollars (or any other non-local currency) that cannot be monetized away by the local central bank. Often, the only choice is a "hard" debt default by the country, which can be devastating for the local economy. In China's case, if its debt bubble does burst, the PBoC should be able to step in to help. But with the country's total debt/GDP now at over 310%, Chinese debt (households, corporates, and the federal and local governments) is past $40trn. In a debt-related financial crisis, the PBoC might have to monetize trillions of dollars of losses.

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1 *https://www.wsj.com/articles/china-boosts-efforts-to-keep-money-at-home-1441120882?mod=article_inline*
2 *https://www.ft.com/content/4ca05a5a-81a3-11e7-a4ce-15b2513cb3ff*
3 *https://www.caixinglobal.com/2019-04-11/imf-warns-china-against-releasing-another-flood-of-stimulus-101402693.html*
4 *https://www.cnbc.com/2019/12/17/chinas-corporate-debt-is-biggest-threat-to-global-economy-moodys.html*
5 *https://www.bloomberg.com/news/articles/2019-12-18/pboc-adviser-warns-of-local-debt-chain-reaction-urges-action*
6 *https://www.cbsnews.com/news/why-the-great-malls-of-china-are-starting-to-crumble/*
7 *https://www.bloomberg.com/news/articles/2018-11-08/a-fifth-of-china-s-homes-are-empty-that-s-50-million-apartments*

…even though China's debt build-up has largely been in its own currency

If this sounds more benign than a "true" EM debt crisis, that is because it is. But new credit growth to the local economy would slow sharply for several quarters as policymakers dealt with debt workouts, cleaned up private-sector balance sheets, recapitalized the financial sector, etc. Growth would likely slow to a crawl. And in a world where trillions of dollars of new RMB was being created to cover debt losses, the Chinese currency would probably have to depreciate sharply.

Either of these two outcomes – a few years of little to no growth in the aftermath of a bursting of the debt bubble, or a rapid devaluation of the RMB because debt losses are being monetized – would be a very big deal for global financial markets. In many ways, China is the single most important economy in the world, more important than even the US. For example, for the past several years, China has replaced the US as the main locomotive of world growth. In 2019, China accounted for roughly a third of total global GDP growth, nearly three times the US contribution. China also has a much more manufacturing- and trade-intensive economy than the US, meaning it is deeply integrated into the world economy (though far less so in global financial markets). In a scenario where China experiences no growth or actually contracts for several quarters, large parts of the world economy would almost certainly tip over into recession, at a time when monetary policy, in particular, already seems stretched.

Similarly, a rapid devaluation of the RMB would be interpreted very negatively by financial markets. China is the largest goods-trading nation in the world and the second-largest importer of services. It is the largest export destination for 33 countries and the largest source of exports for 65.[8] If the RMB were to suddenly weaken by, say, 15-20% relative to the USD, other countries would quickly have to weaken their currencies to remain competitive, sparking sharp flight-to-quality moves into safe havens such as the USD, the JPY, and the CHF. So even though China may not face a traditional emerging market-type crisis, its debt build-up carries significant downside risks.

The chronicles of China: The debt, the capital flight, and the currency

And yet, none of these risks have materialized. Yes, Chinese corporate debt defaults did hit a record last year,[9] but the numbers are manageable (tens of billions of dollars in a $13trn-plus economy), and the defaults are occurring precisely because authorities are no longer willing to bail out troubled borrowers.[10] In a macro context, China has been able to manage its debt burden without sparking a financial crisis, at least so far. We believe much of the credit for this more benign outcome is because China has not had to combat capital flight in recent years, certainly not on the scale of what it faced in 2015. Consider 2019. The country was in the throes of a trade war with the United States, growth slowed sharply compared with previous years, and Chinese authorities allowed USDCNY to weaken past the psychological 7 RMB level for the first time in over a decade. And yet, China's FX reserves, which drop if capital flight picks up,[11] barely budged.

Now consider 2015. The country's currency reserves dropped by more than a trillion dollars from the 2014 peak, including over half a trillion dollars in CY2015 (Figure 1). This was not because the PBoC was using its FX reserves to defend the RMB in the financial markets. China's capital account is not fully open, so the RMB is not freely convertible; the PBoC's intervention in the USDCNY markets could hardly have been to the tune of a trillion dollars.

[8] *https://www.mckinsey.com/~/media/mckinsey/featured%20insights/china/china%20and%20the%20world%20inside%20the%20dynamics%20of%20a%20changing%20relationship/mgi-china-and-the-world-full-report-june-2019-vf.ashx*

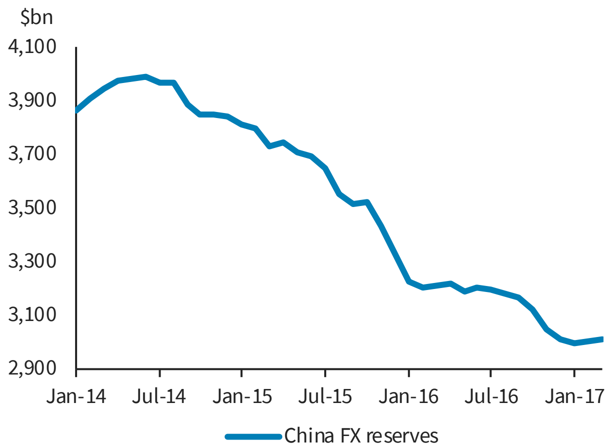
[9] *https://asia.nikkei.com/Economy/China-s-corporate-bond-defaults-hit-record-23bn-as-bailouts-fade*

[10] We would argue that this is a positive sign; Chinese authorities are no longer willing to bail out every distressed firm.

[11] Assuming no changes in the current account balance

FIGURE 1

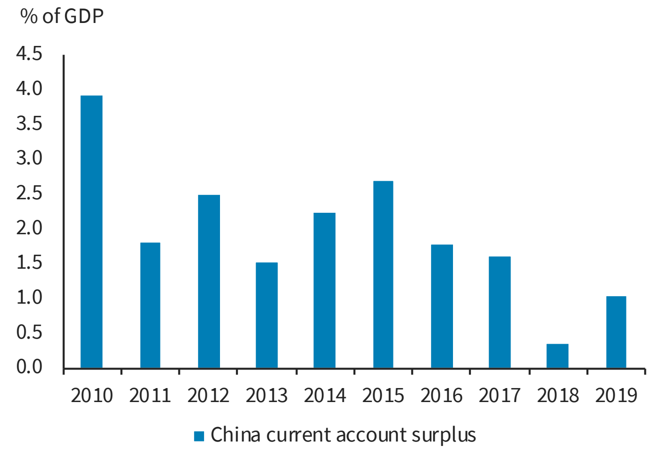
China FX reserves fell sharply in 2015



Source: Bloomberg, Barclays

FIGURE 2

China no longer runs a large current account surplus



Source: IMF, Barclays

FX reserves dropped because domestic savings (both households and corporates) fled the country. And the drop in FX reserves arguably understates the true extent of capital flight, since the country also ran a healthy current account balance in 2015 (almost 3% of GDP). In other words, the rest of the world showed up at China's doorstep with hundreds of billions of dollars and China still saw FX reserves fall by a trillion dollars. In sharp contrast, its FX reserves were stable in 2019, even though its current account surplus shrank (Figure 2).

Why was this capital flight of 2015 so significant? It is worth remembering that financial crises play out not on the asset side of the balance sheet but on the liability side. For example, investors spent months worrying about the asset side of Lehman Brothers' balance sheet in 2008. But it was only when the liability side reacted in response – through a wholesale funding "run" – that the Great Financial Crisis started. Similarly, investors have spent years worrying about the asset side of China's balance sheet. But if an asset turns out to be unproductive and the related loan goes bad, a command-and-control economy has greater ability to "extend and pretend" than market-based systems. The terms of the loan can be improved, local officials can provide regulatory relief, and the bank need not "pull the plug" and classify the loan as a bad loan (which could come with greater capital requirements and hurt the bank's ability to extend new credit).

Of course, if an asset is truly unproductive, it will eventually filter through to the bottom line, whether for a bank or for the economy as a whole. But this can play out across many, many income statements (akin to deflating a debt bubble) or through a violent, one-time balance sheet adjustment (in other words, a financial crisis). From 2016 to 2020, China seems to have successfully been able to adopt the former approach.

But the "extend-and-pretend" approach cannot work if there is a funding crisis for the financial sector itself – and 2015 was the closest China came to this risk being realized. Sustained capital flight that year was a function of domestic savings leaving the country. While those savings stayed inside China, they helped fund its financial sector (either as bank deposits or as shadow banking liabilities). If the capital flight of 2015 had continued, it could have eventually sparked a funding crisis for parts of China's domestic financial sector.[12] And that, in turn, could have led to a broader financial crisis.

[12] There are also other negatives associated with capital flight and declining FX reserves; countries can struggle to fund necessary imports (such as on commodities in the case of China), and it can hurt local asset prices, lead to rapid currency depreciation, etc.

Comparing 2020 and 2015: The bad news first

So why are there no signs of a "run" on China Inc. this time around? After all, the economy is weaker than in 2015, the Shanghai Composite is still well below its 2015 average, the RMB is much weaker, and leverage in the economy is greater. And this is even before we factor in the economic and social effects of COVID-19. There are other negatives as well. China started 2015 with $4trn in currency reserves; it starts 2020 with $900bn less, even though its financial system and economy are significantly larger. China also ran a healthy current account surplus in 2015, while it is now close to flat. Moreover, China's commitment to buying more US products over the next few years (as part of the recently concluded US-China trade deal) could put further pressure on its capital account balance.[13] Finally, even though the bulk of China's debt remains in local currency, external (non-RMB) liabilities have increased materially in recent years and are now a much larger share of the country's currency reserves than in 2015. In many ways, China seems less prepared to withstand capital flight now than five years ago.

And yet, financial systemic concerns about China seem muted. Yes, investors are worried about the growth effects of the virus, but that's a far cry from the intense market gyrations in the second half of 2015. Why is that? Perhaps an easier way to approach this topic is to ask what drove the capital flight of 2015. What happened that year? Did over a billion Chinese citizens and the corporate sector suddenly and collectively lose confidence in the currency and the government; was that why there was such a large capital flight? We think not. Rather, we believe that several factors acting together led to the capital flight of 2015 – and those conditions are no longer in place.

Learning from past mistakes

First, we believe that Chinese authorities have learned from the 2015 experience and become much better at stemming capital flight. Our sense is – and we are admittedly guessing here – that the scale of the 2015 rush for the exits took China's government by surprise, especially since it involved both legal and illicit methods. Illegal money transfer agents that acted as underground banks, a proliferation of foreign-currency denominated insurance products, companies' over-invoicing and inflating the value of imports as a way to transfer large sums abroad, a flurry of overseas acquisitions by large Chinese firms – these and other schemes all hit the headlines that year as ways that Chinese citizens were moving money abroad.[14]

Since then, China has put in place several measures to prevent a repeat. It has tightened approvals for cross-border acquisitions, monitored overseas spending, increased disclosure requirements for individuals buying foreign currency, restricted overseas insurance products, discouraged domestic cryptocurrency exchanges, and penalized individuals and corporates that have attempted to evade these rules. The Chinese government is unlikely to be caught by surprise if capital flight resurfaces. The government has also been actively trying to attract capital inflows by opening up the onshore market, given the structural decline in the current account. These efforts have achieved some success, with the inclusion of Chinese bonds in major benchmark bond indices (Figure 3), as well as the sharp increase in the weight of China A shares in the MSCI equity indices.[15]

[13] *https://live.barcap.com/go/publications/content?contentPubID=FC2434042*, Can China become a deficit economy?
[14] *https://www.wsj.com/articles/china-boosts-efforts-to-keep-money-at-home-1441120882?mod=article_inline*
[15] These money inflows could eventually be a double-edged sword if they leave Chinese financial assets vulnerable to sudden outflows.

Admittedly, controls on capital outflows can only go so far. China also has ambitions to internationalize its currency and eventually liberalize its capital account, the exact opposite of controls. Capital controls can also add friction to trade, negatively affect FDI flows into the country and financial inflows (because investors worry about the ability to repatriate profits), and impinge on personal freedoms (such as the right of each Chinese citizen to transfer $50,000 worth of savings out of the country every year). Capital controls help, but they are not a silver bullet.

USD strength and the absence of the CFETS RMB index

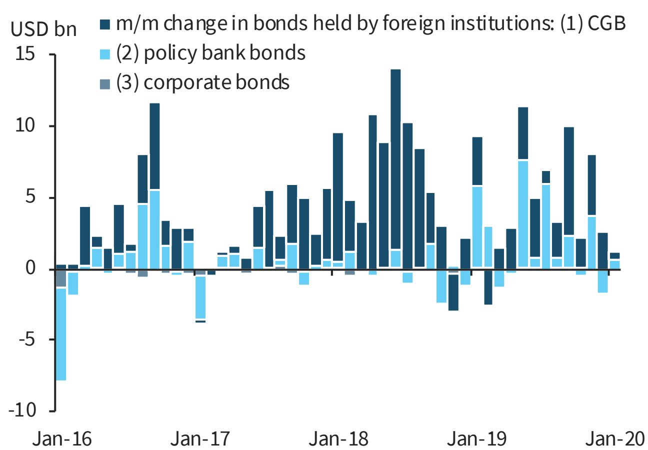
But a couple of other factors also contributed to the capital flight of 2015. One was the performance of the US dollar. From the middle of 2014 to late 2015, the USD rose 12-15% (trade weighted) in anticipation of the first Fed hiking cycle of the decade (Figure 4). Importantly, this was a period when the China Foreign Exchange Trade System had not yet set up the CFETS RMB index against which it now manages CNY fixings. In the run-up to 2015, investors had thus become used to looking at the RMB primarily through the prism of the USDCNY cross. In many ways, it seemed as if the RMB had an implicit peg to the US dollar. And in fact, as the USD strengthened across H2 2014 and H1 2015, the RMB strengthened in lockstep against other currencies.

When currency pegs – whether implicit or explicit – break, currency moves can often be violent. For example, when the Swiss National Bank scrapped its euro peg in 2015, the CHF strengthened as much as 30% against the EUR in a matter of minutes and ended the day more than 10% stronger. In the same vein, markets reacted violently when the PBoC allowed the RMB to depreciate 3% against the USD in August 2015. On the face of it, 3% was not a very strong move, especially for a currency that had steadily strengthened (on a trade-weighted basis) in the first half of that year. If China had had a CFETS RMB index in place, the PBoC could have explained to investors that it was merely ensuring that the RMB remained stable against its trade-weighted index, which is why it was no longer moving in line with the USD. Presumably, investors would have been far less worried. As it was, financial markets reacted very poorly and capital flight picked up – not because of the 3% move, but because of concerns that there might be a lot more to come as China's implicit peg with the USD broke.

In contrast, China now has a CFETS index in place that investors watch closely. And while the USD has been resilient in recent months, we do not expect a sustained new Fed hiking cycle for the rest of 2020. As a result, our baseline does not call for a new round of sharp

FIGURE 3

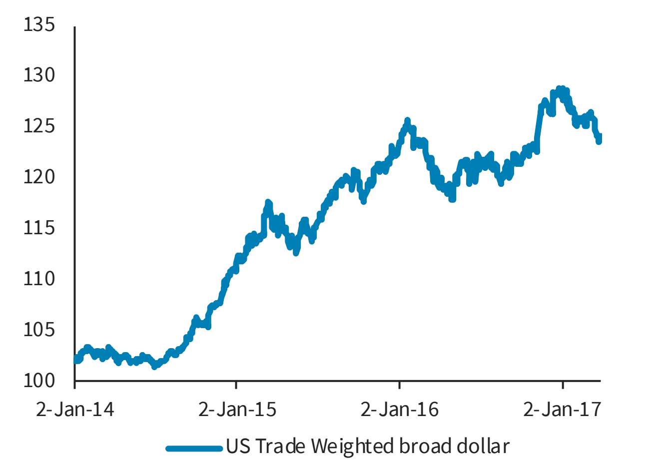
Inflows to China's financial markets in recent years



Source: Barclays

FIGURE 4

USD strengthened sharply from mid-2014



Source: Bloomberg, Barclays

and sustained USD strength, a factor that played a significant role in the events of 2015. We are also comforted by the experience of last year, when China orchestrated a significant devaluation against the USD (with USDCNY at one point touching 7.15) without a material downshift in its FX reserves.

Money supply growth is far more subdued than in 2015

There was one more driver, in our view, of the 2015 capital flight episode: the sharp increase in Chinese domestic money supply that year. As Figure 5 shows, M1 growth in China had been in the single digits in the first half of the decade, in line with the slowdown in nominal GDP growth. But that changed at the start of 2015. The economy continued to slow that year, in both real and nominal terms. In fact, China's GDP deflator was negative in 2015, and nominal GDP growth was just 6%, yet M1 growth went from 3% in 2014 to a peak of 25% in mid-2016.

The obvious conclusion is that Chinese authorities pumped large amounts of excess liquidity into the domestic economy that year in an effort to support slowing growth. That would be less problematic in an economy where the currency is freely traded and market forces could ensure that the currency weakens appropriately. But the RMB is not freely traded, and the PBoC's first attempt to allow the currency to weaken (the 3% devaluation of August 2015) was met with alarm by markets. Considering the large amount of excess domestic liquidity, coupled with a currency that could not reflect that liquidity in its market value, in hindsight, it is not surprising that a significant portion leaked out – ergo, the capital flight of 2015.

In contrast, Chinese authorities have been careful not to follow that approach more recently. M1 growth is running at just 4%, and money supply in the domestic economy has been relatively stable over the past few years, not expanding rapidly. This time around, Chinese authorities do not seem willing to flood the economy with excess liquidity in an effort to support economic growth – a far cry from the macro conditions that, we believe, led to the flight of domestic capital from the country five years ago.

Conclusion

It is impossible to parse the extent to which each of the factors above contributed to China's 2015 challenges, and other factors were at work as well. For example, President Xi's aggressive ant-corruption campaign that year might also have contributed to the phenomenon of money fleeing the country. China also experienced a sharp stock market collapse in summer 2015, with stock prices falling more than a third from their peak in just a few months (Figure 6). The government's responses to the stock market drop – such as a four-month ban on new IPOs,[16] as well as preventing major shareholders from selling shares[17] – likely did not help investor confidence. None of these factors are currently in place; the conditions that drove the events of 2015 no longer exist. We would need to see months of capital flight, along the lines of 2015, and a sustained decline of several hundred billion dollars in China's FX reserves before we become concerned about the risk to global financial markets.

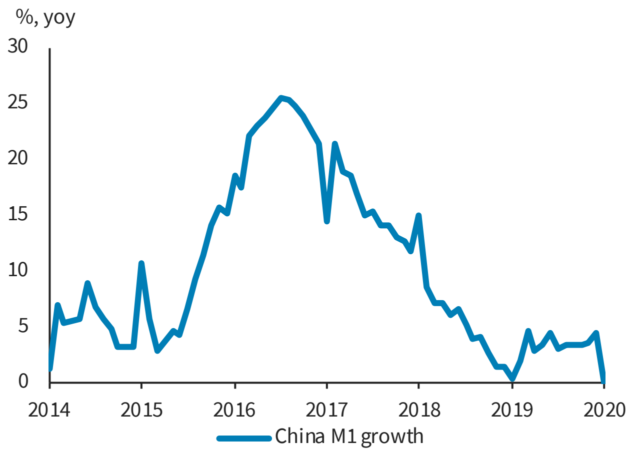
There are many things to worry about when it comes to China, as with every major economy. Investors should rightly focus on issues such as the extent to which global supply chains will be affected by COVID-19, when the country will recover fully from the virus, what will be the next driver of growth, etc. But worries about the financial systemic risk posed by China should not, in our view, be on this list, at least for the next several quarters.

[16] *https://www.ft.com/content/44455dda-8473-11e5-9dc0-186bb1146746*

[17] *https://www.theguardian.com/world/2015/jul/09/china-bans-major-shareholders-from-selling-their-stakes-for-next-six-months*

FIGURE 5

Sharp rise in M1 growth in China in 2015-16



Source: Bloomberg, Barclays

FIGURE 6

Chinese equities fell very sharply in summer 2015

Source: Bloomberg, Barclays

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