COULD CHINA EXPERIENCE SOME KIND OF ‘CURRENCY CRISIS’ IN THE NEXT FEW YEARS?

PRESENTATION TO INDEPDENDENT ECONOMICS

16TH APRIL 2024

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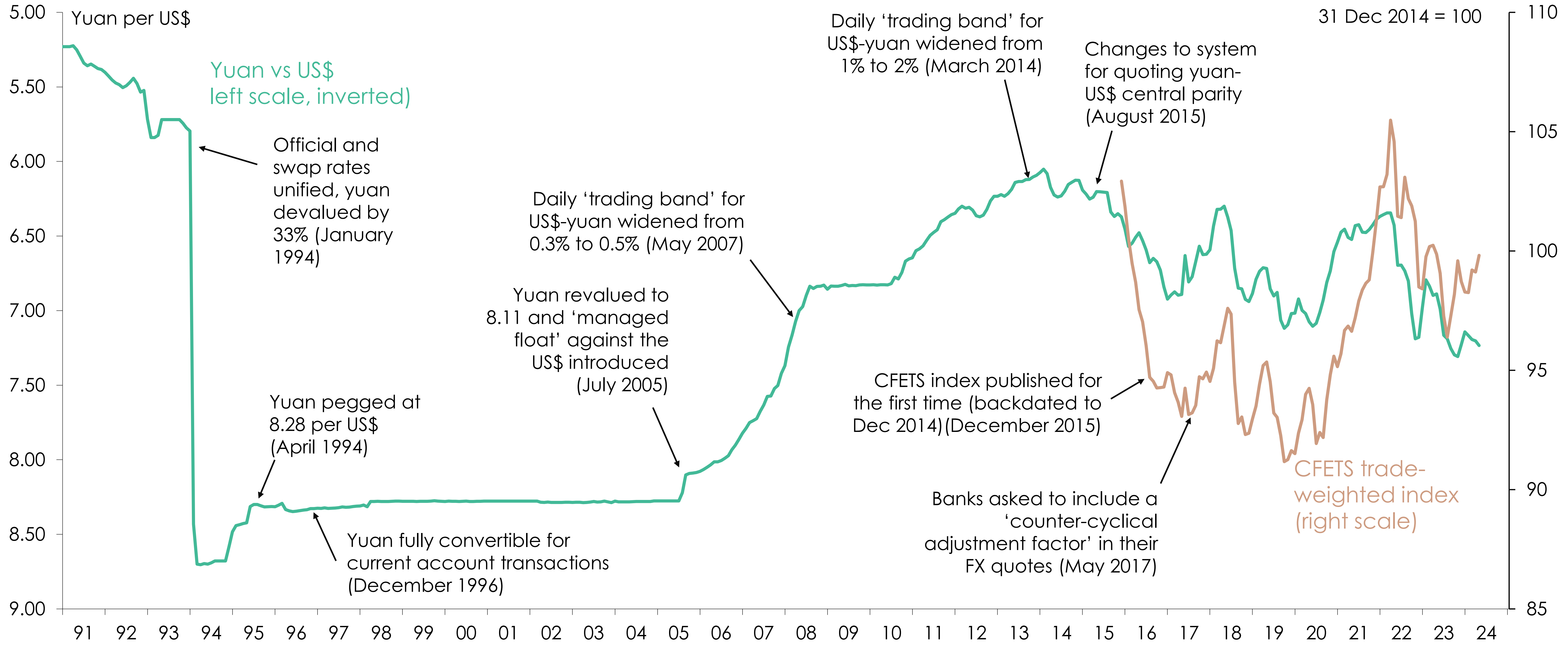
Over the past 18 years China's exchange rate regime has evolved from a fixed peg to the US$ to a 'crawling peg' against a trade-weighted index

Chinese yuan vs US dollar and China Foreign Exchange Trading System (CFETS) trade-weighted index



Sources: LSEG Refinitiv Datastream; People's Bank of China.

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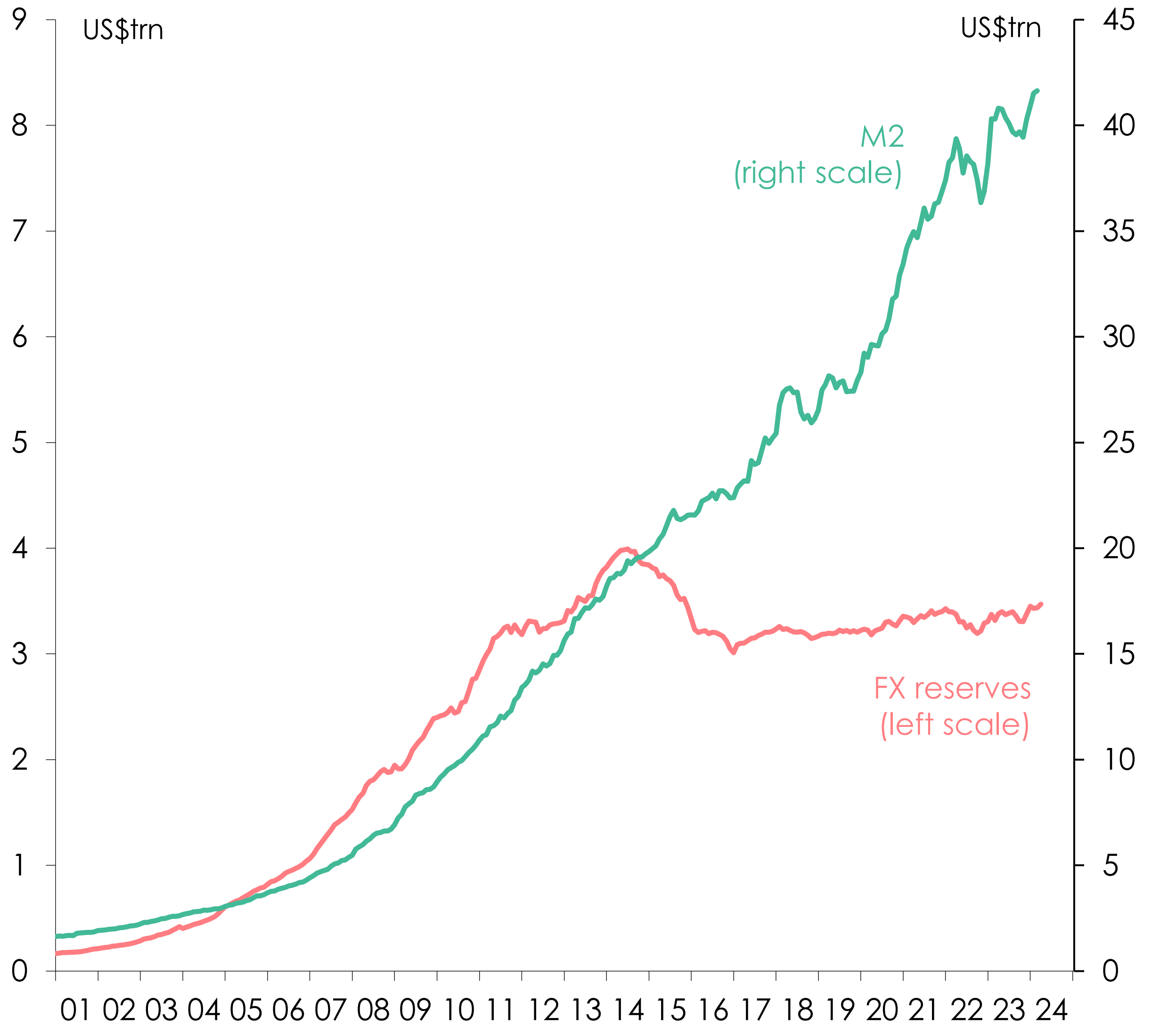
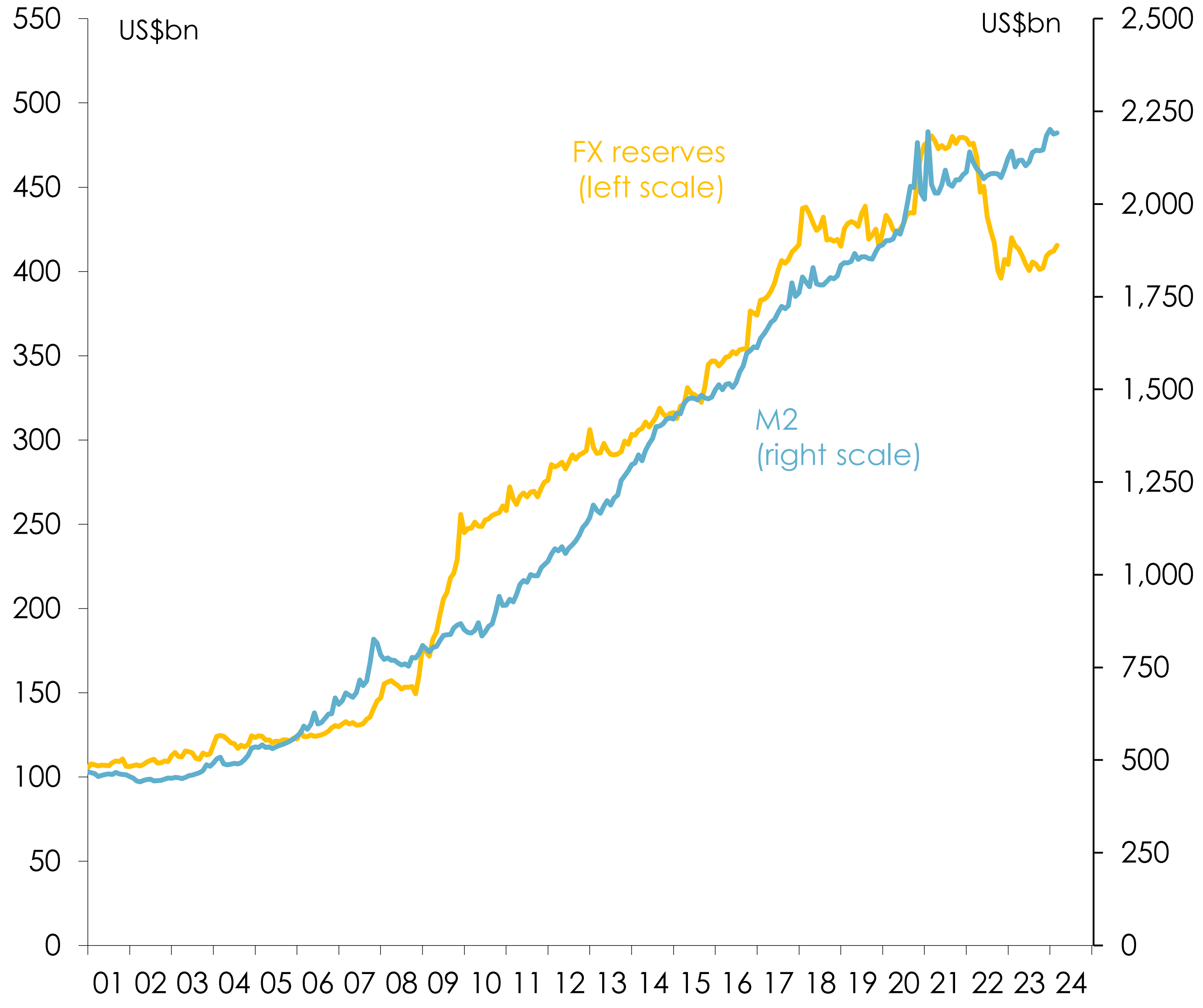
Since 2015 China hasn't maintained a roughly linear relationship between FX reserves and its domestic money supply

China's FX reserves and M2 money supply



Hong Kong's FX reserves and M2 money supply



Sources: People's Bank of China; Hong Kong Monetary Authority.

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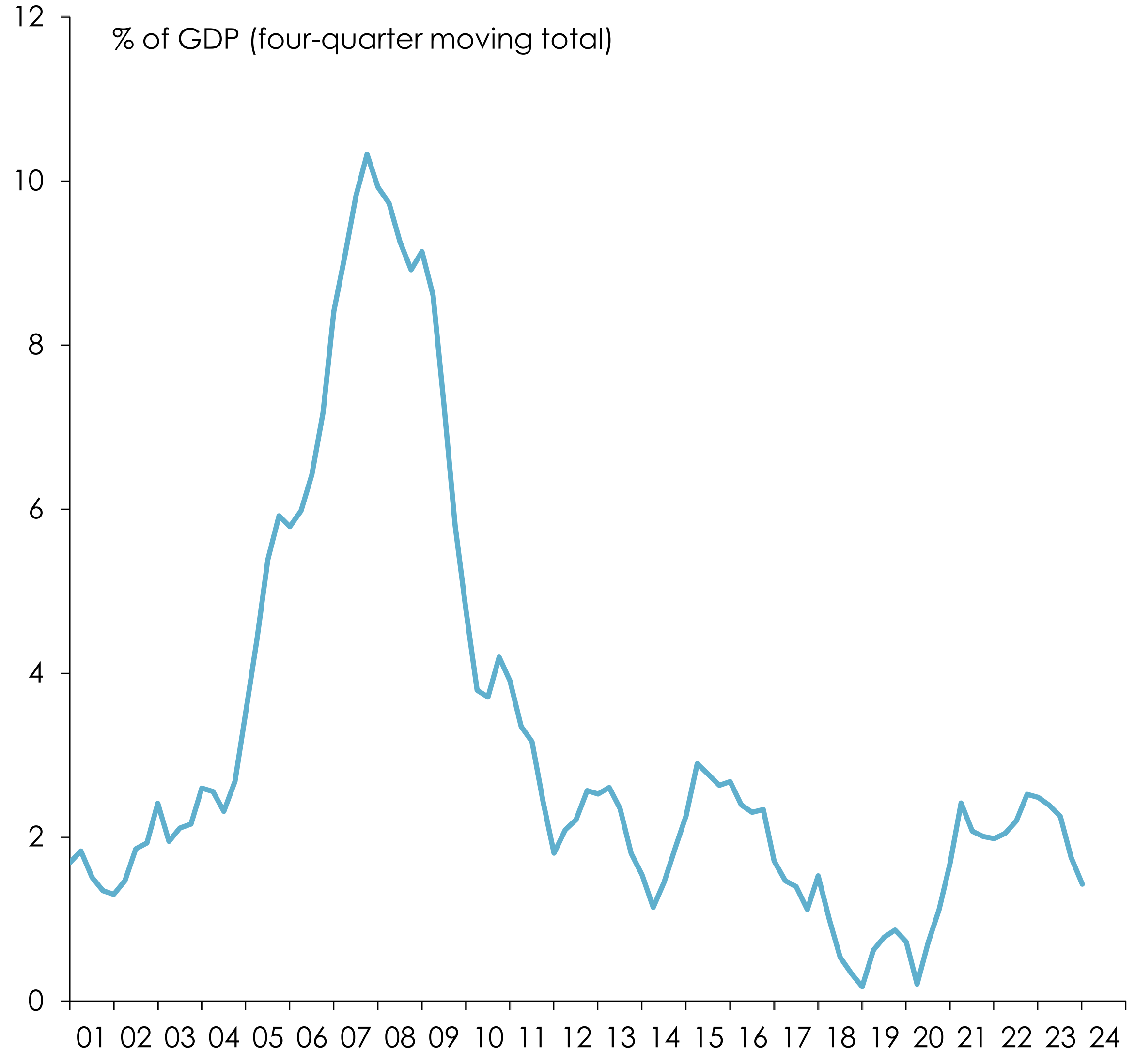
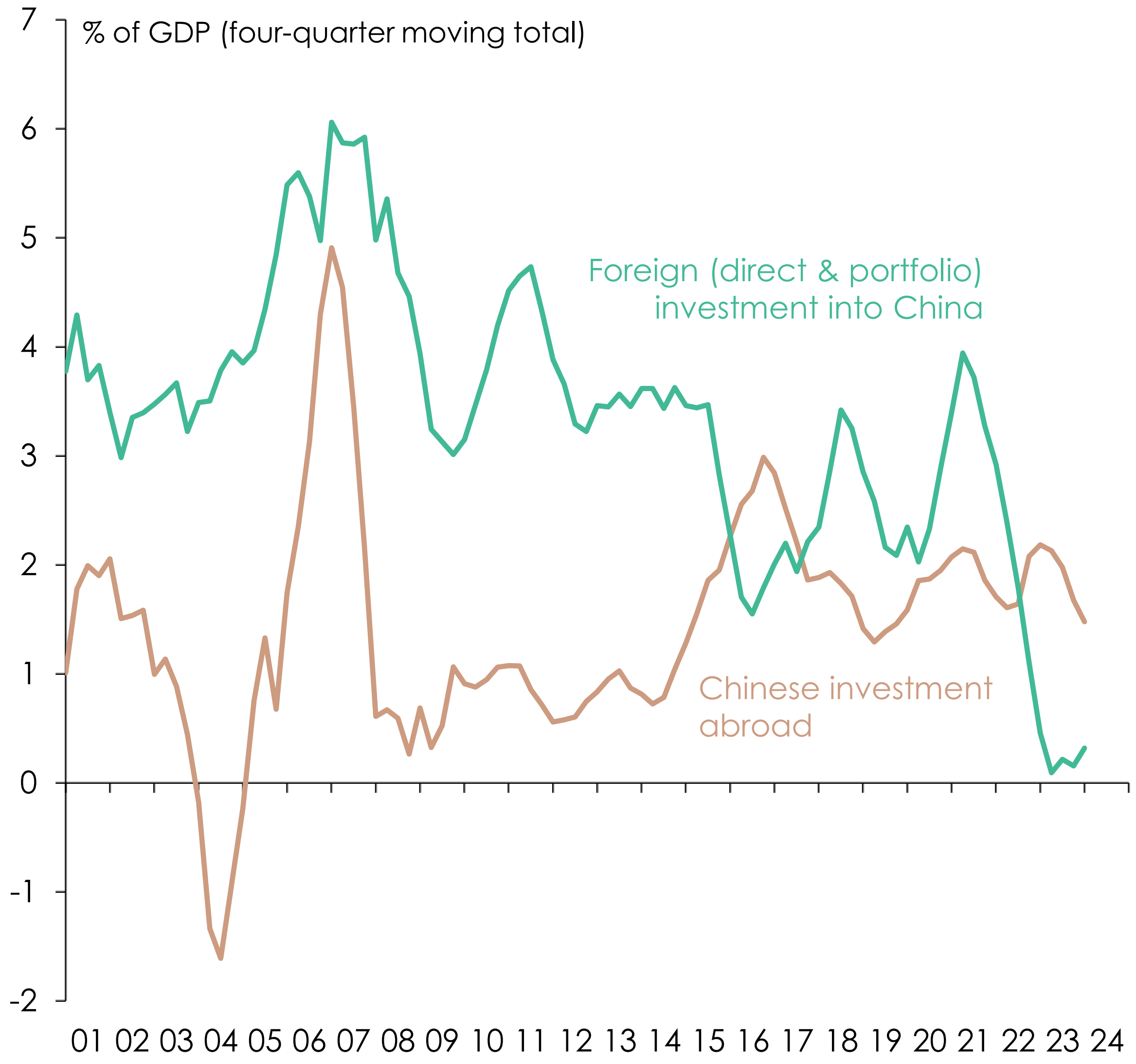
China's 'basic balance' surplus has shrunk from over 14% of GDP in 2007 to a still-large 3.2% of GDP in 2021 but then to just 0.3% of GDP in 2023

China's current account surplus



China's foreign investment inflows and outflows



Sources: China State Administration of Foreign Exchange; National Bureau of Statistics of China.

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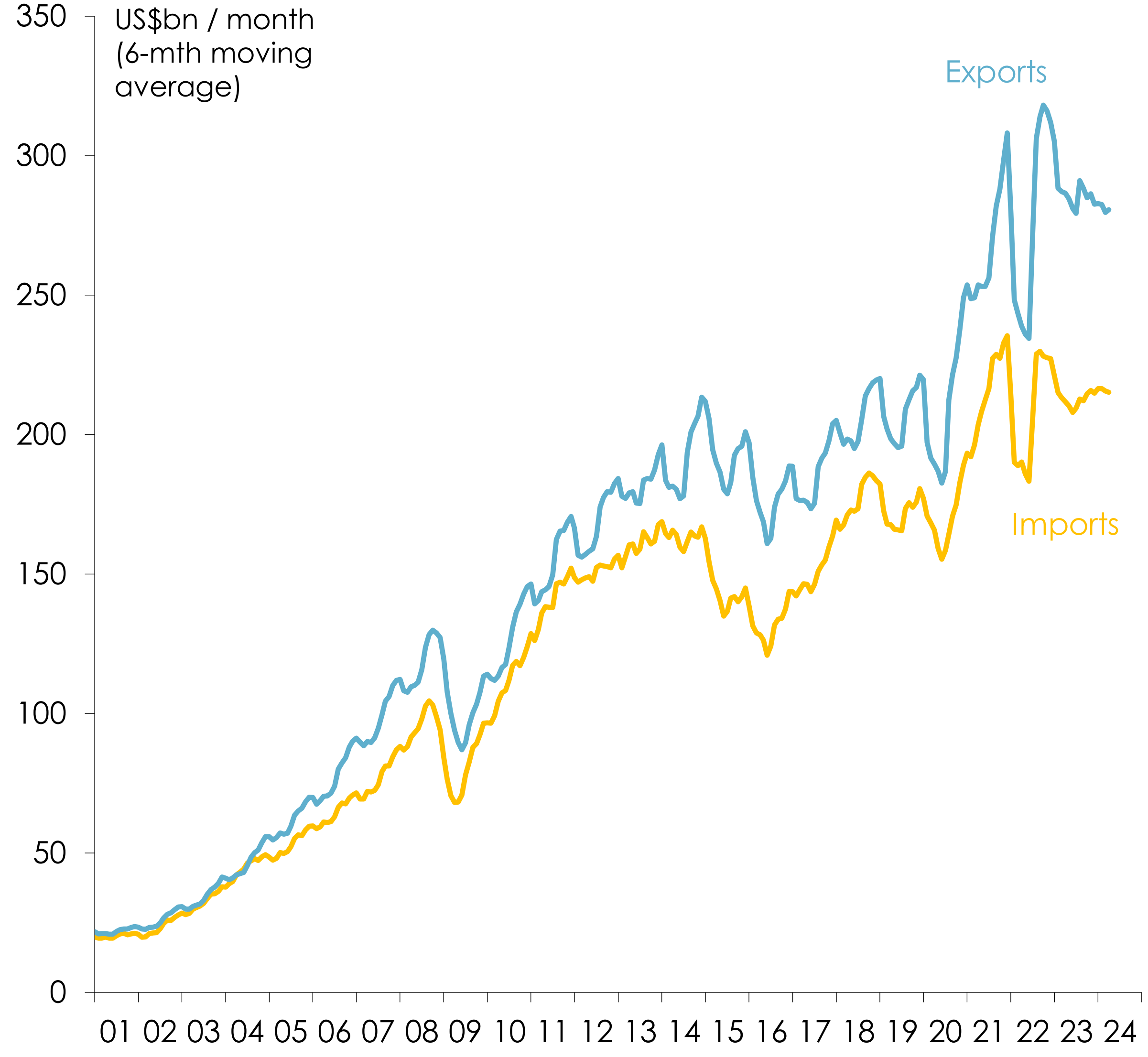
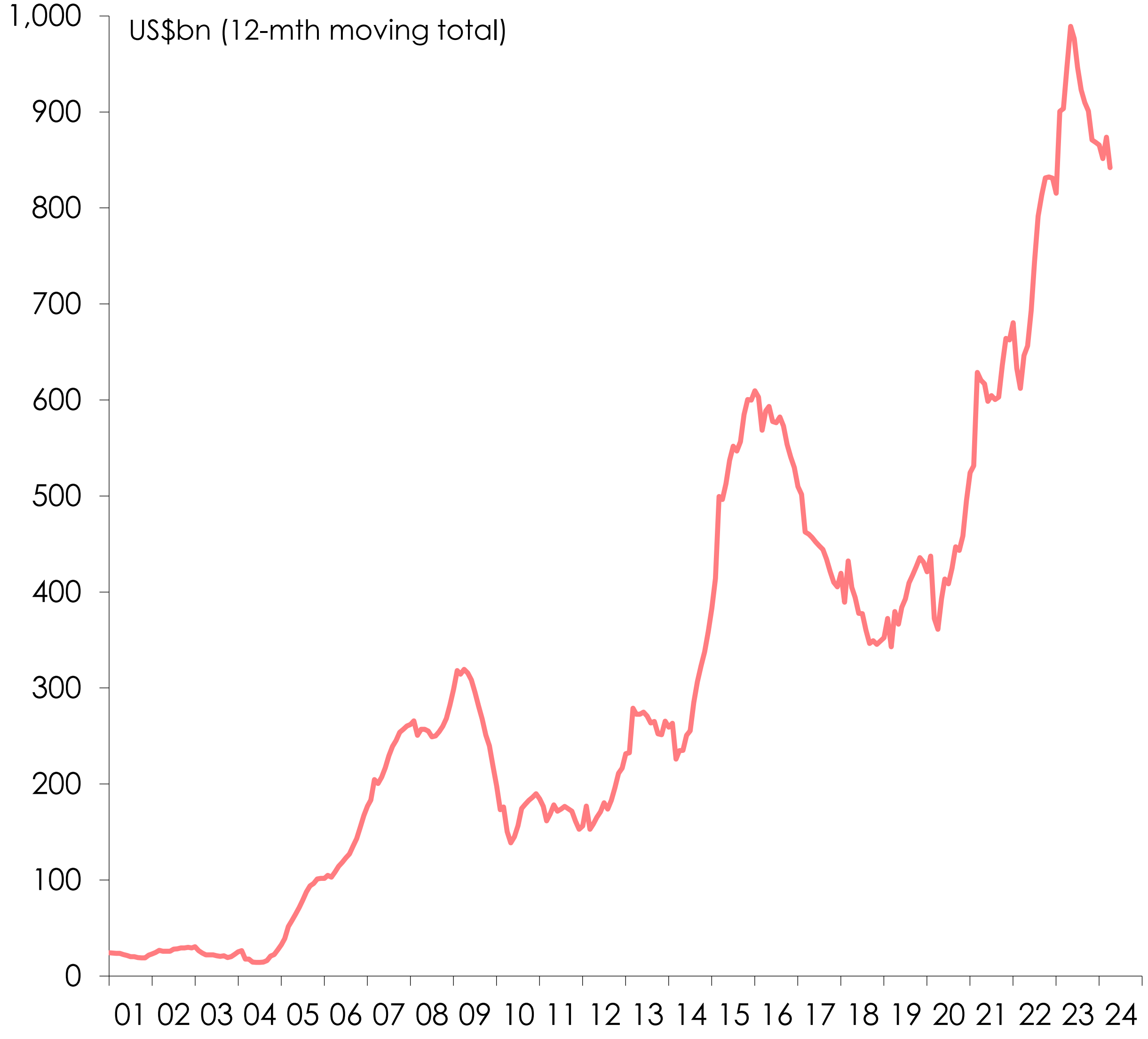
China's merchandise trade surplus is being sustained by weakness in imports, not strength in exports

China's merchandise exports and imports



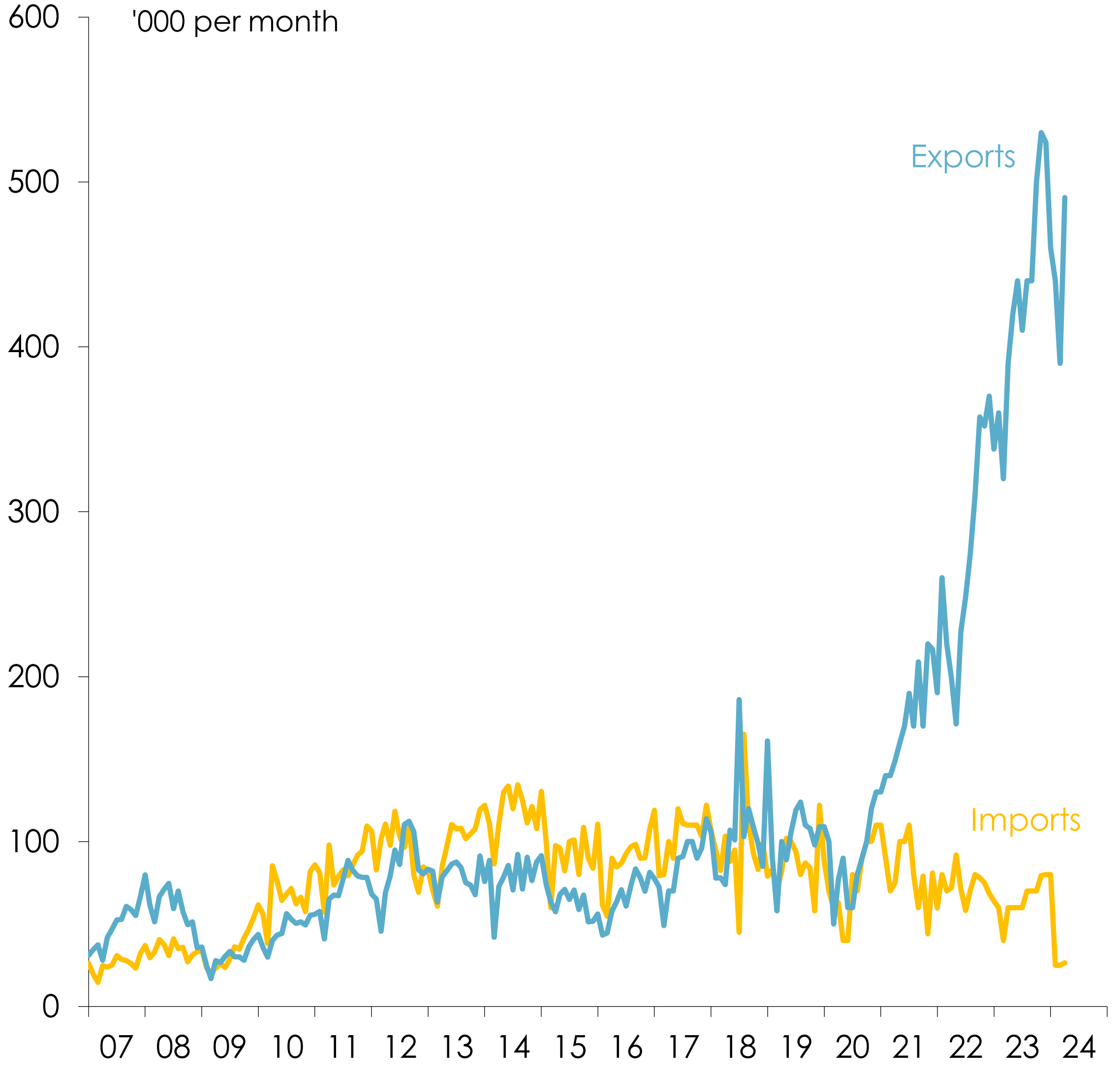
China's merchandise trade surplus



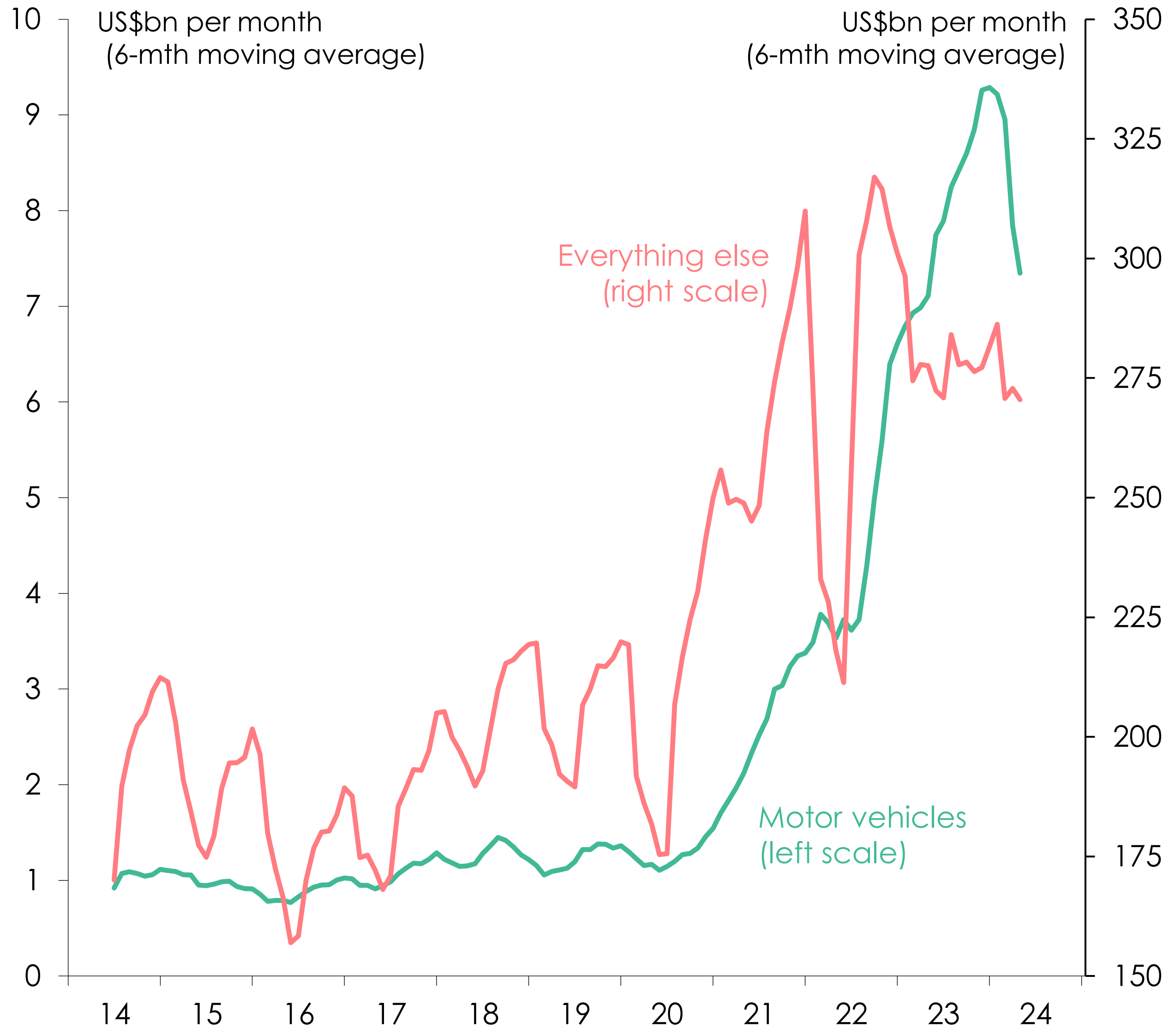
Source: General Administration of Customs.

China's motor vehicle exports are booming – but that also highlights the weakness in China's other exports

China's motor vehicle exports and imports



Motor vehicle and other merchandise exports



Sources: China National Bureau of Statistics; General Administration of Customs;.

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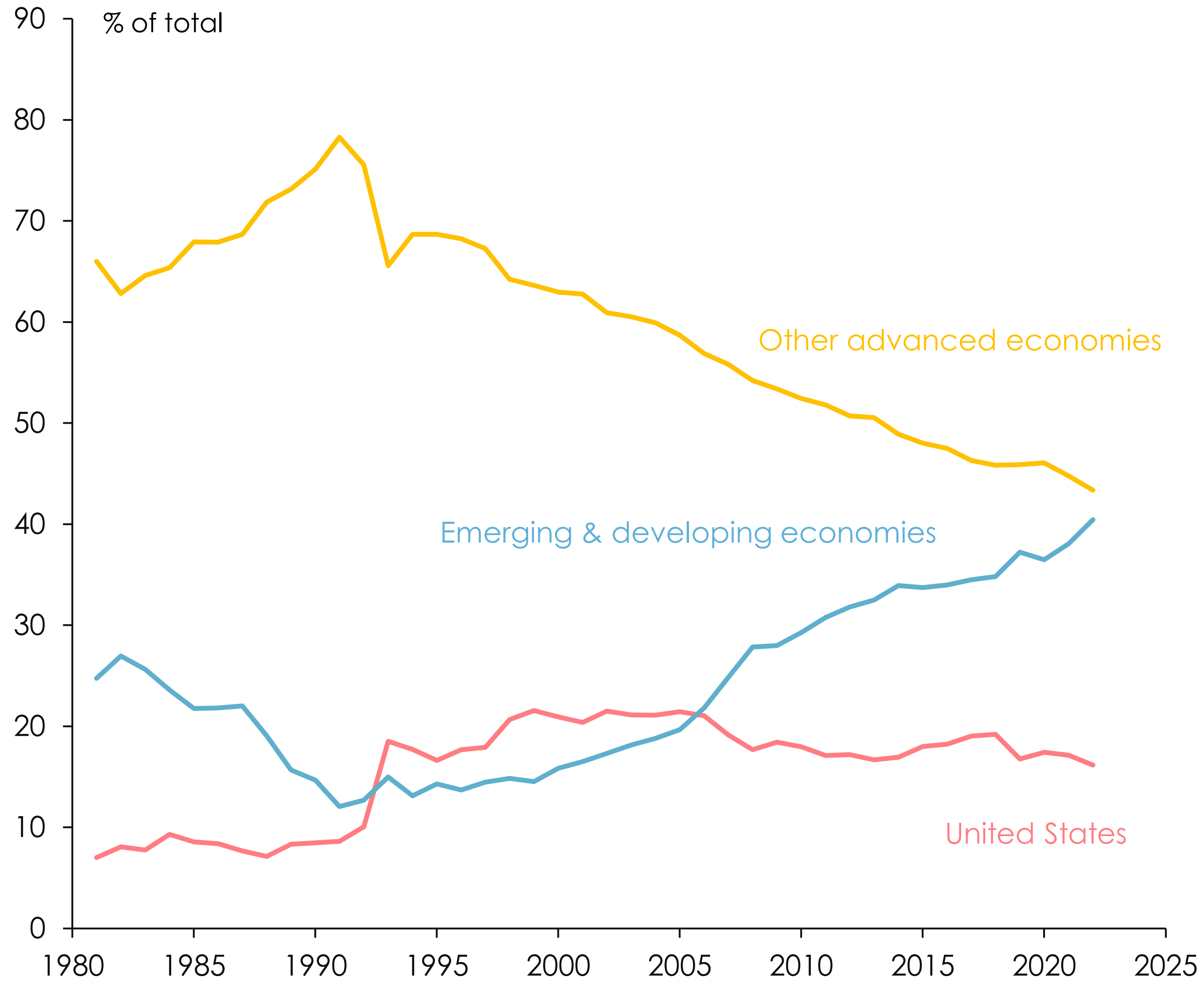
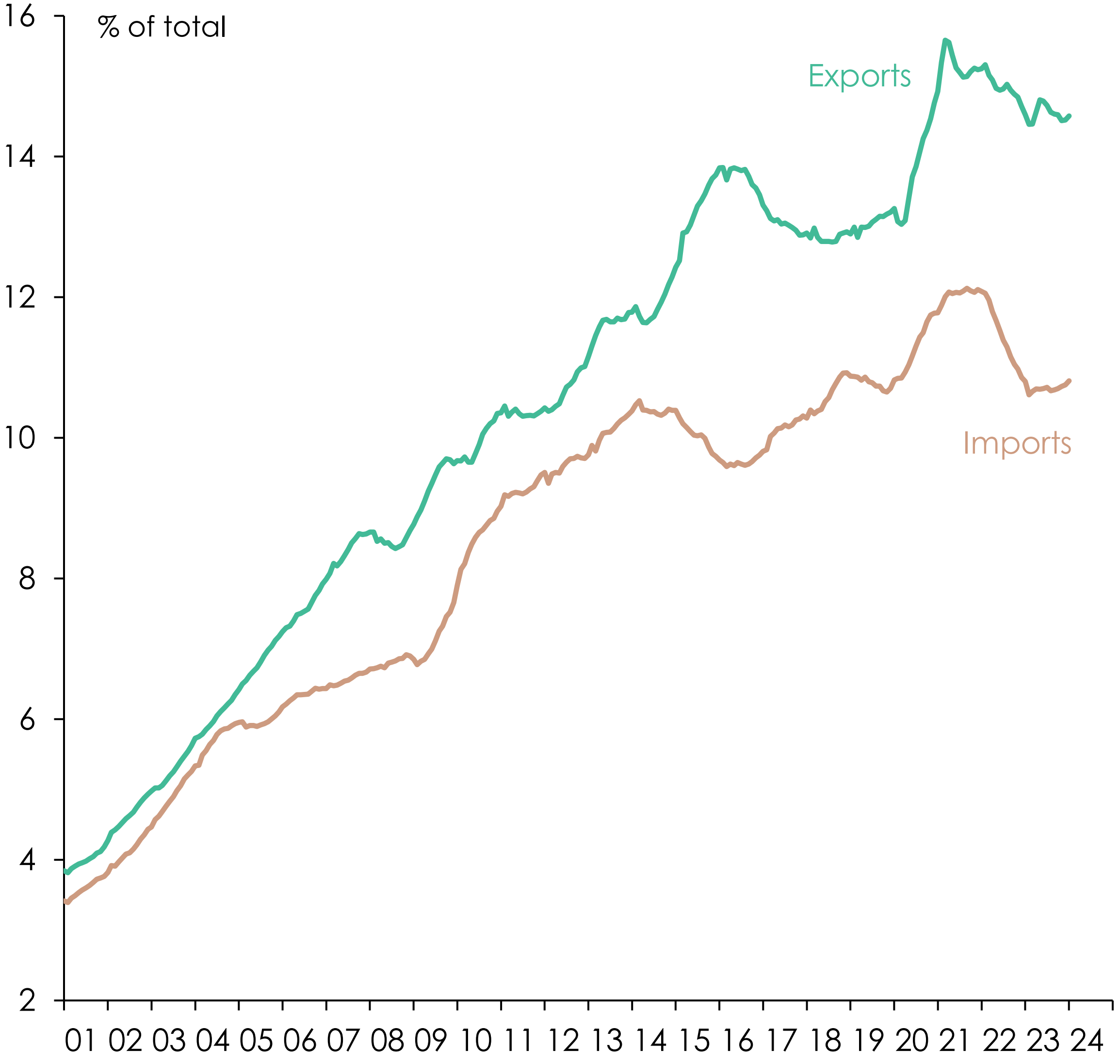
China is lifting its share of exports to the 'global south' – but that's being offset by market share losses in 'advanced' economies

China's merchandise exports, by destination



China's share of total world merchandise trade



Sources: World Trade Organization, WTO Stats; International Monetary Fund, Direction of Trade Statistics.

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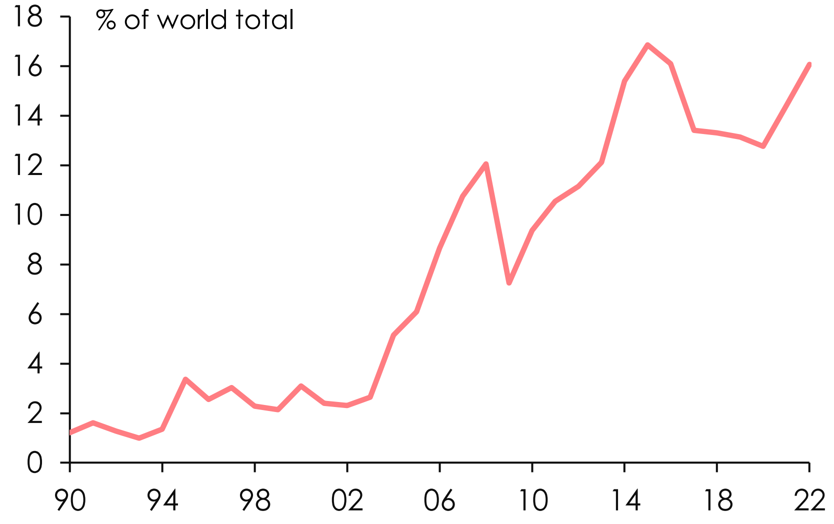
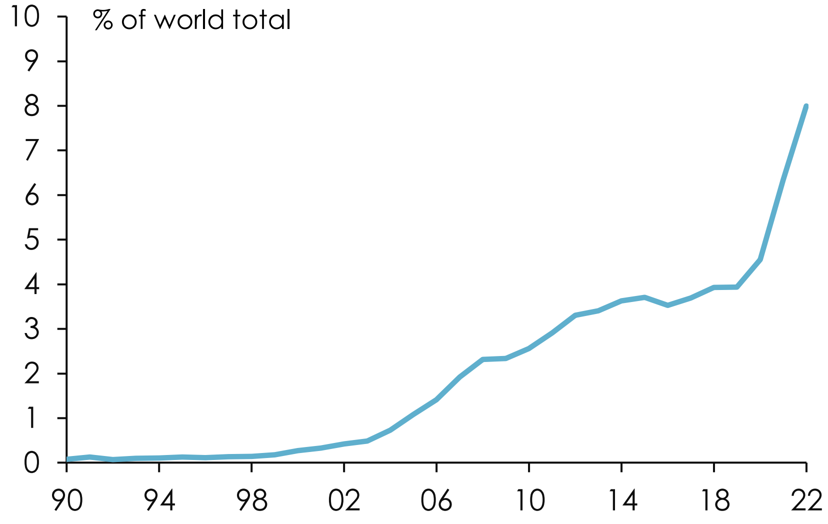
Except in automotive products, it is likely to be difficult for China to increase its global market share of major export product groups

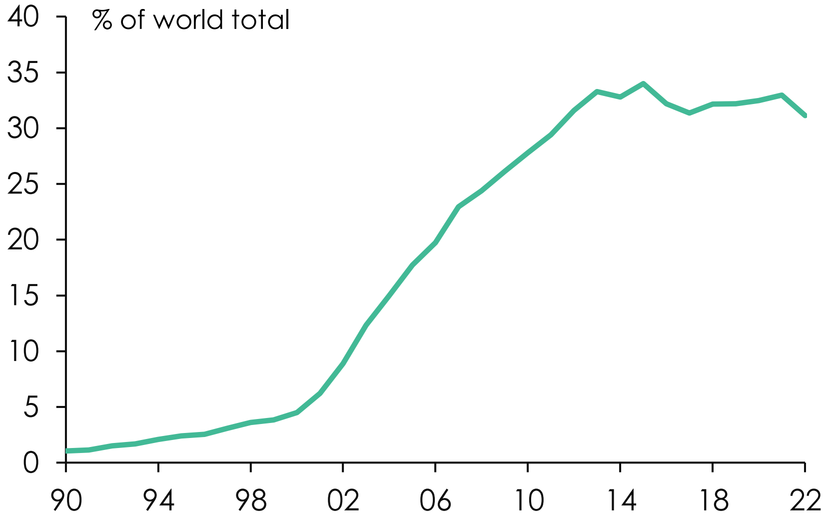
Iron & steel



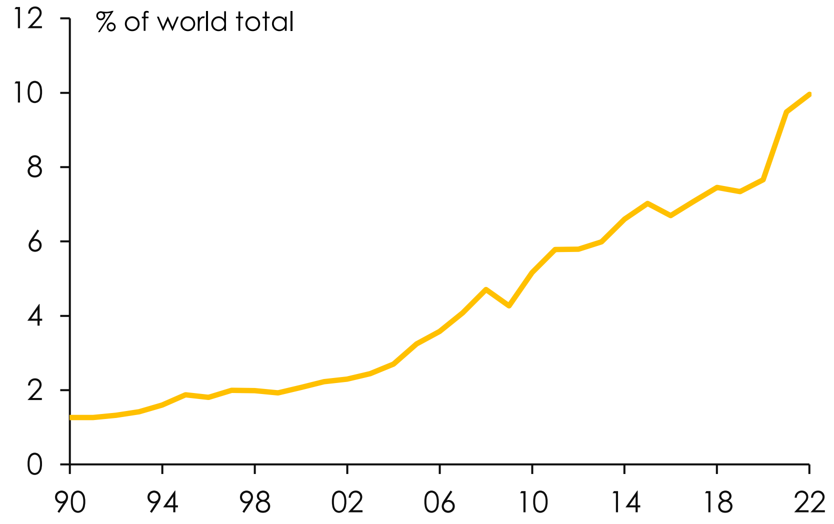
Automotive products



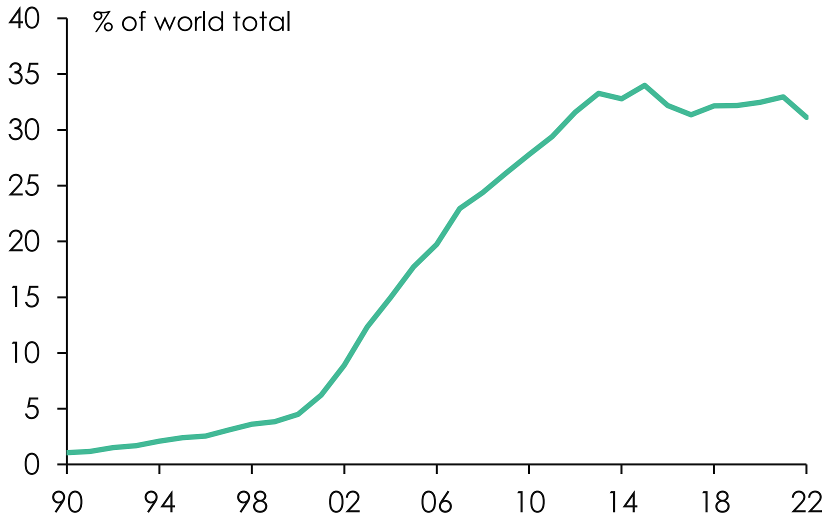
Other machinery & equipment



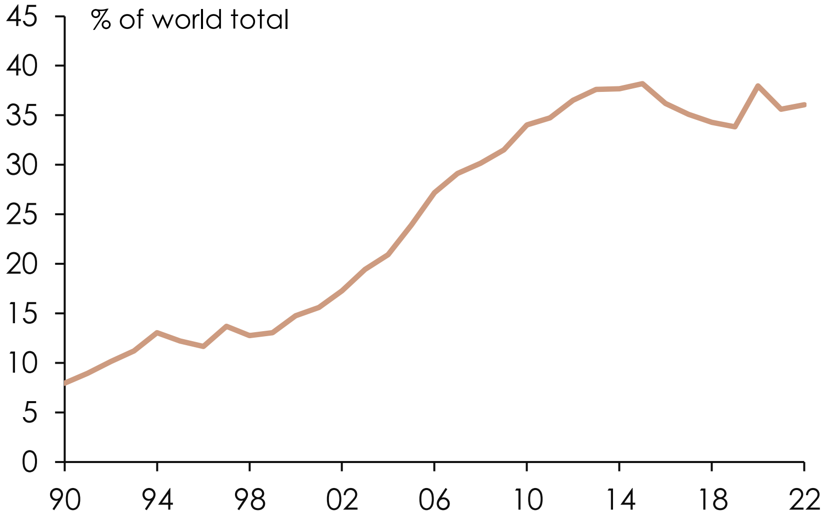
Chemicals



Office & telecoms equipment



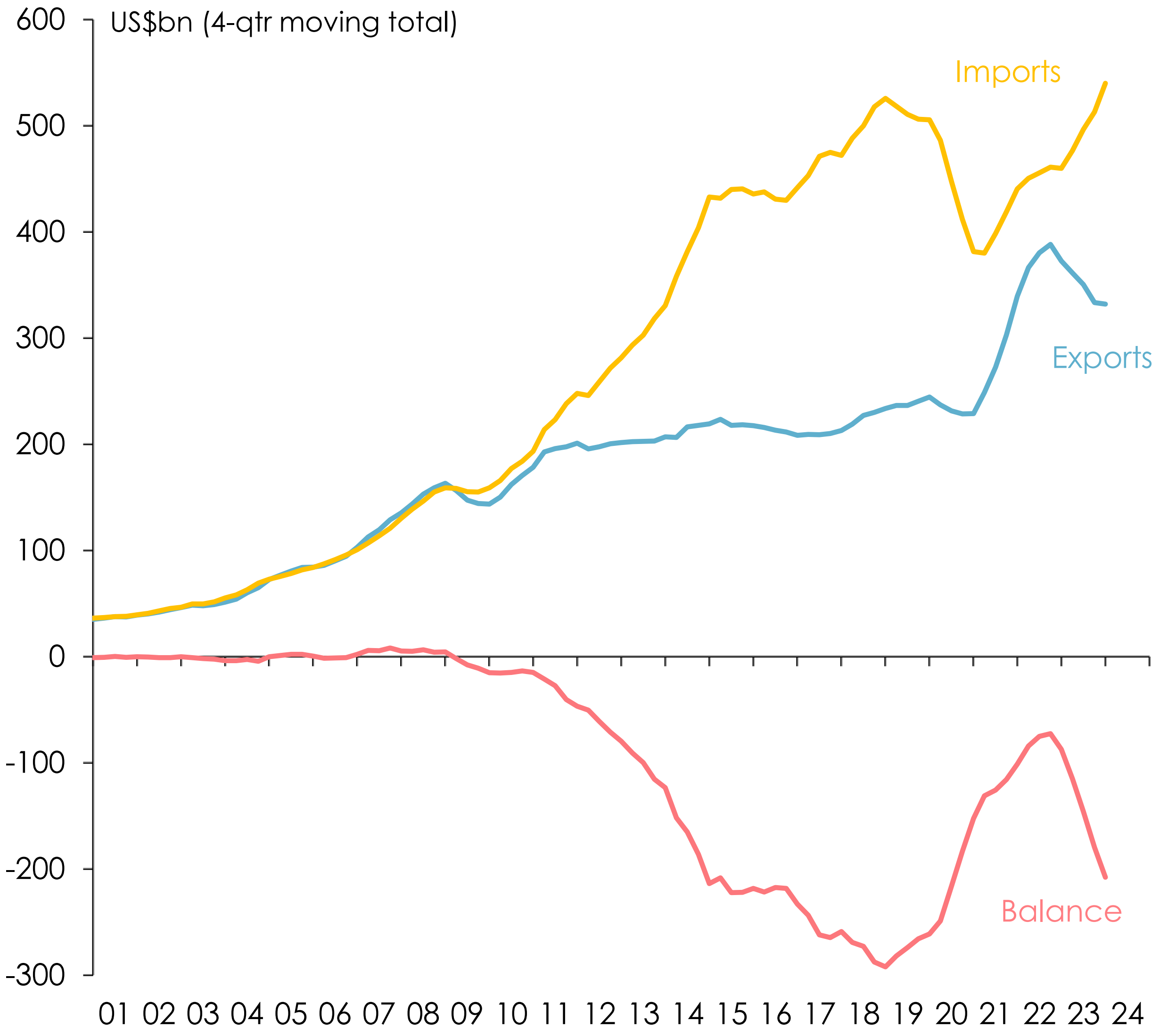
Textiles & clothing



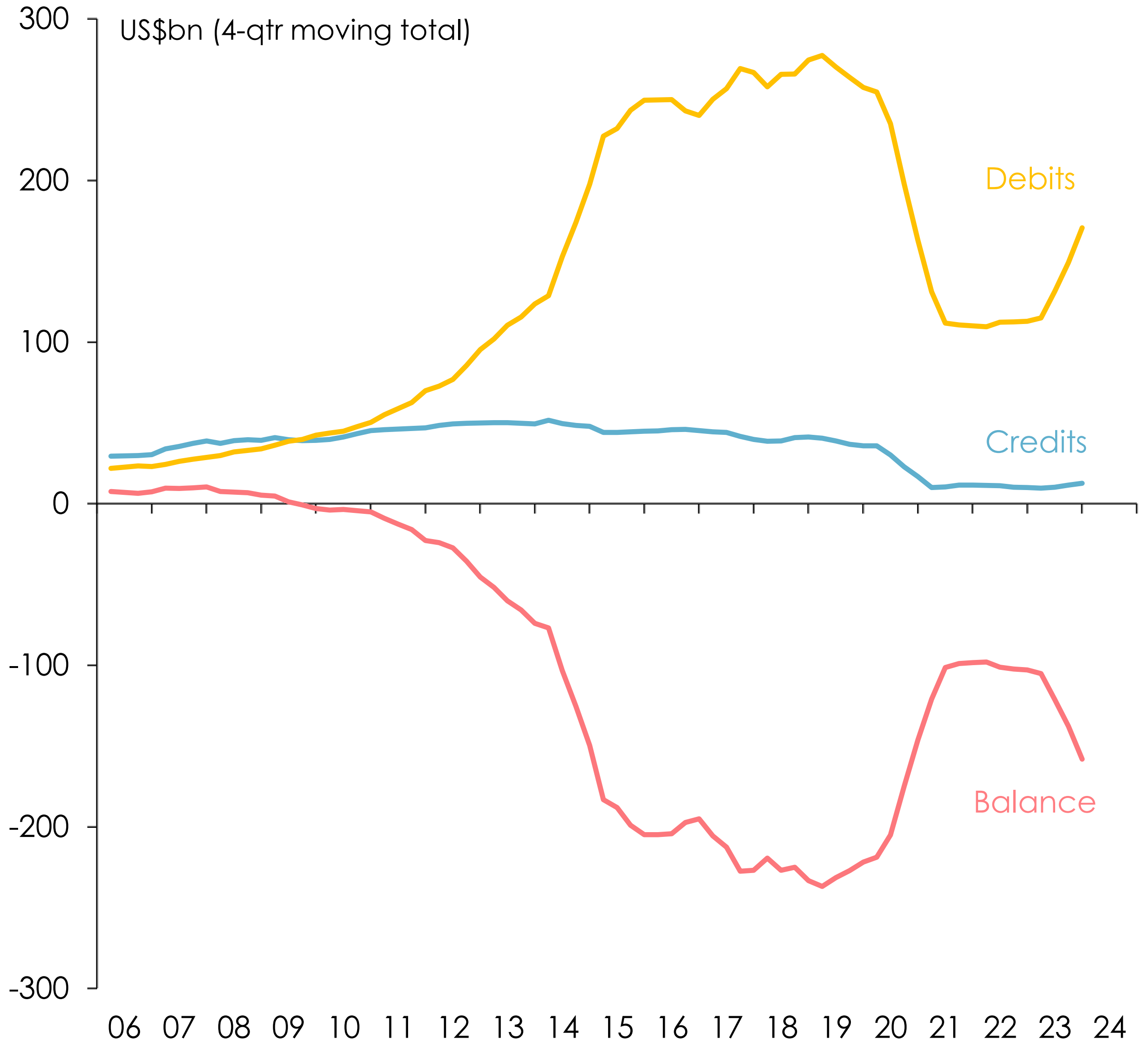
Source: World Trade Organization, WTO Stats.

China's services trade deficit is widening – largely because while lots of Chinese want to travel abroad, not many foreigners want to go to China

China's services trade



China's travel credits and debits



Source: China State Administration of Foreign Exchange.

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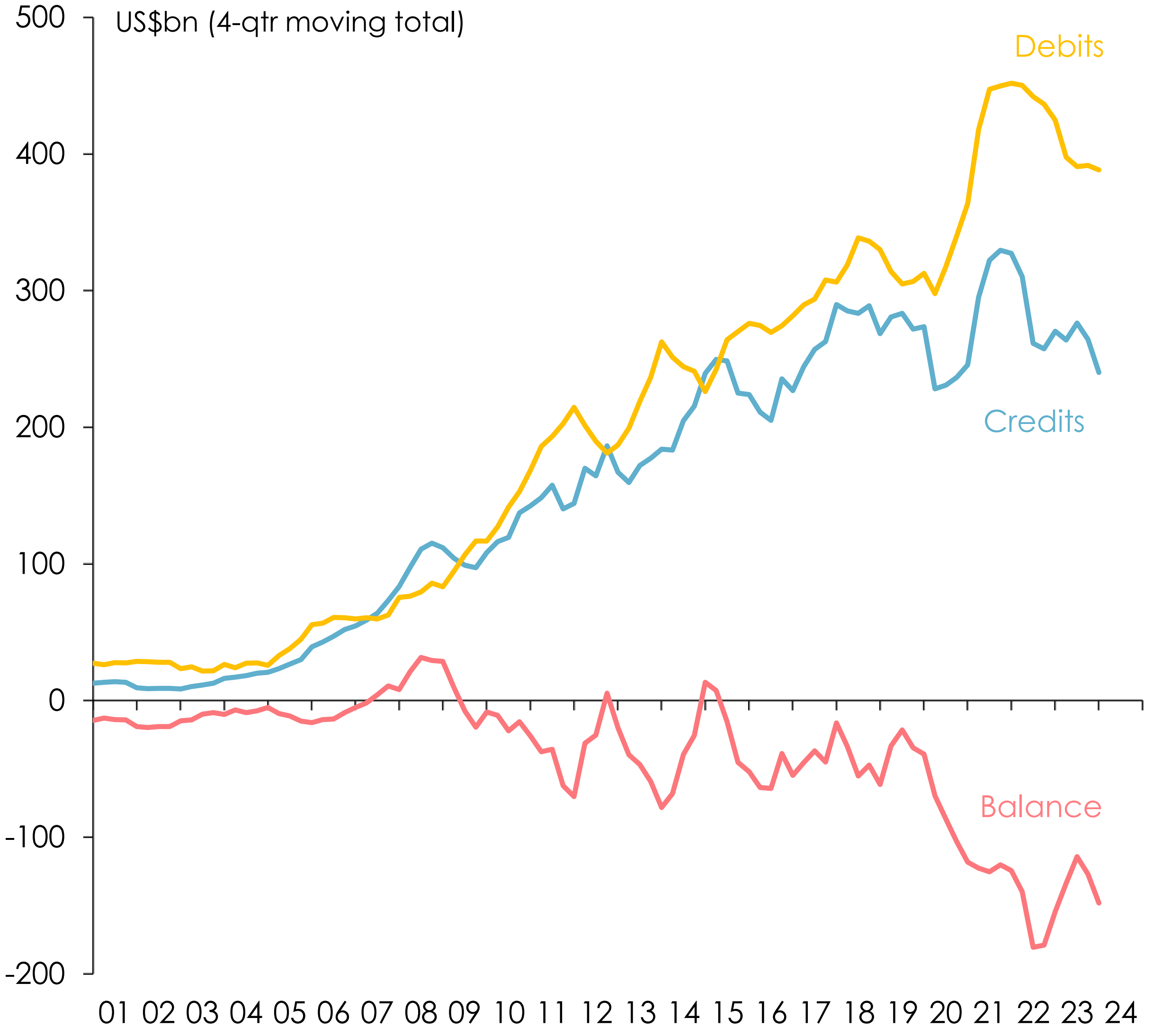
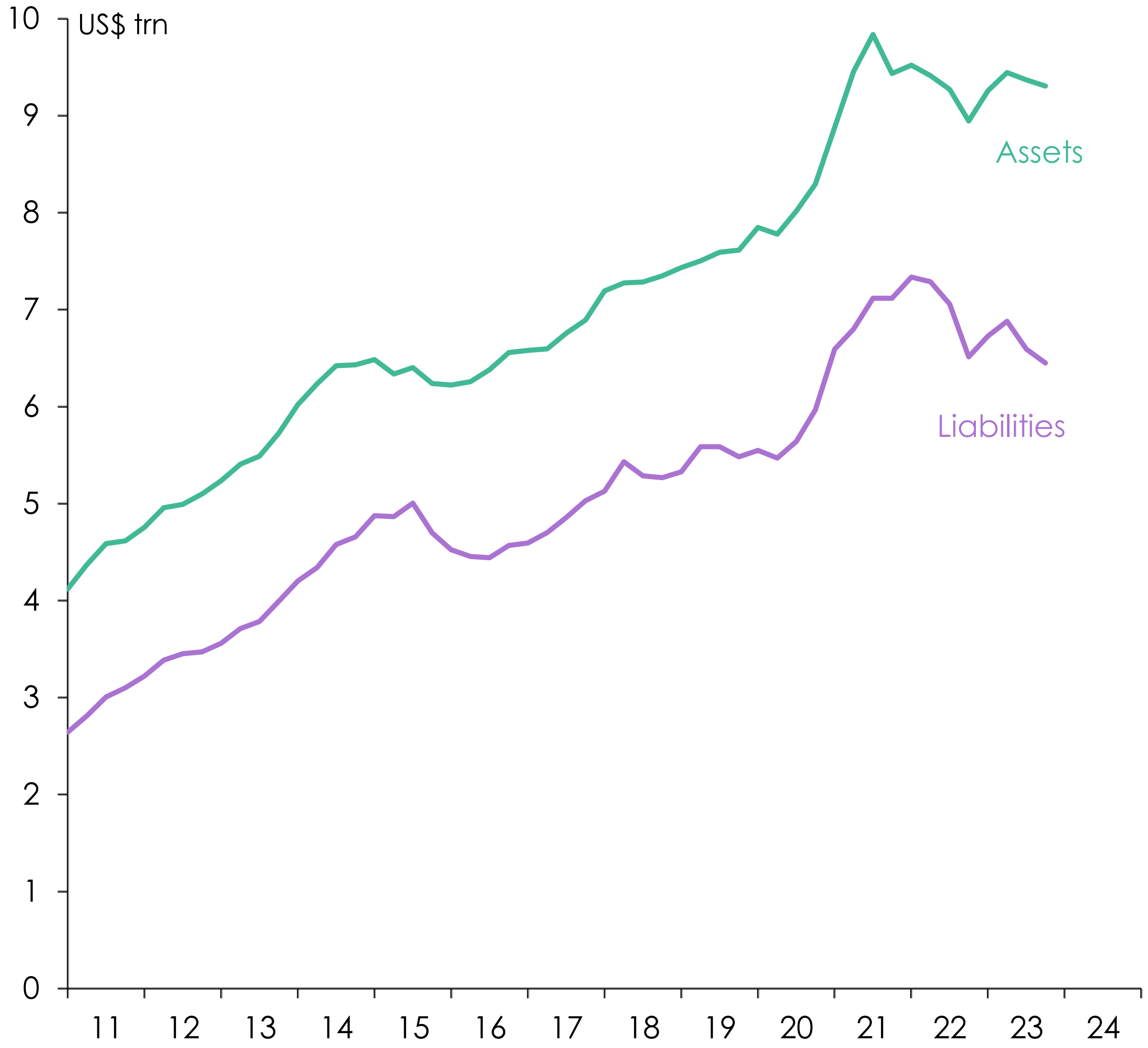
China runs a deficit on primary income despite being a significant international creditor (the opposite of the United States

China's primary income credits and debits



China's net international asset position



Source: China State Administration of Foreign Exchange.

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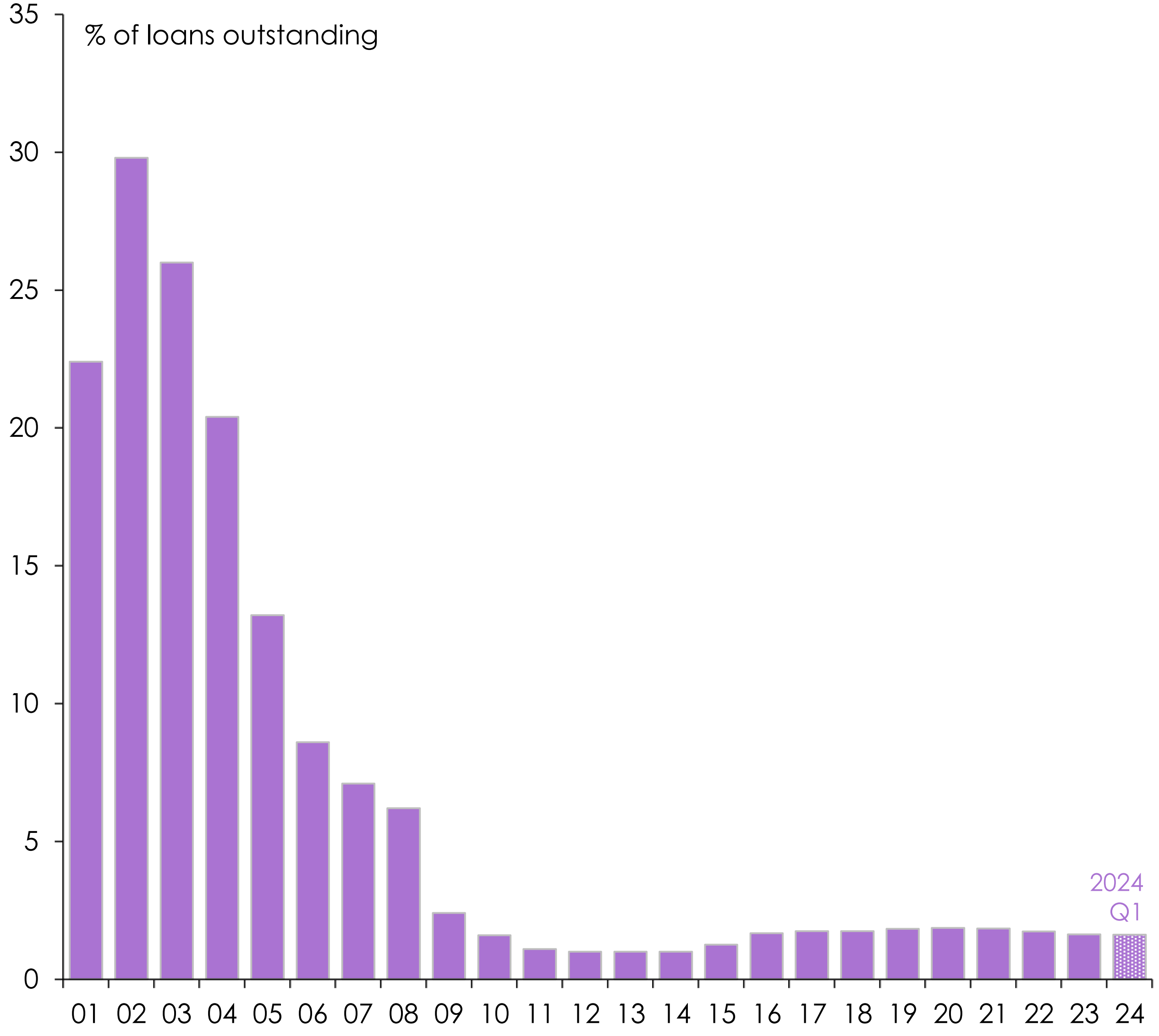
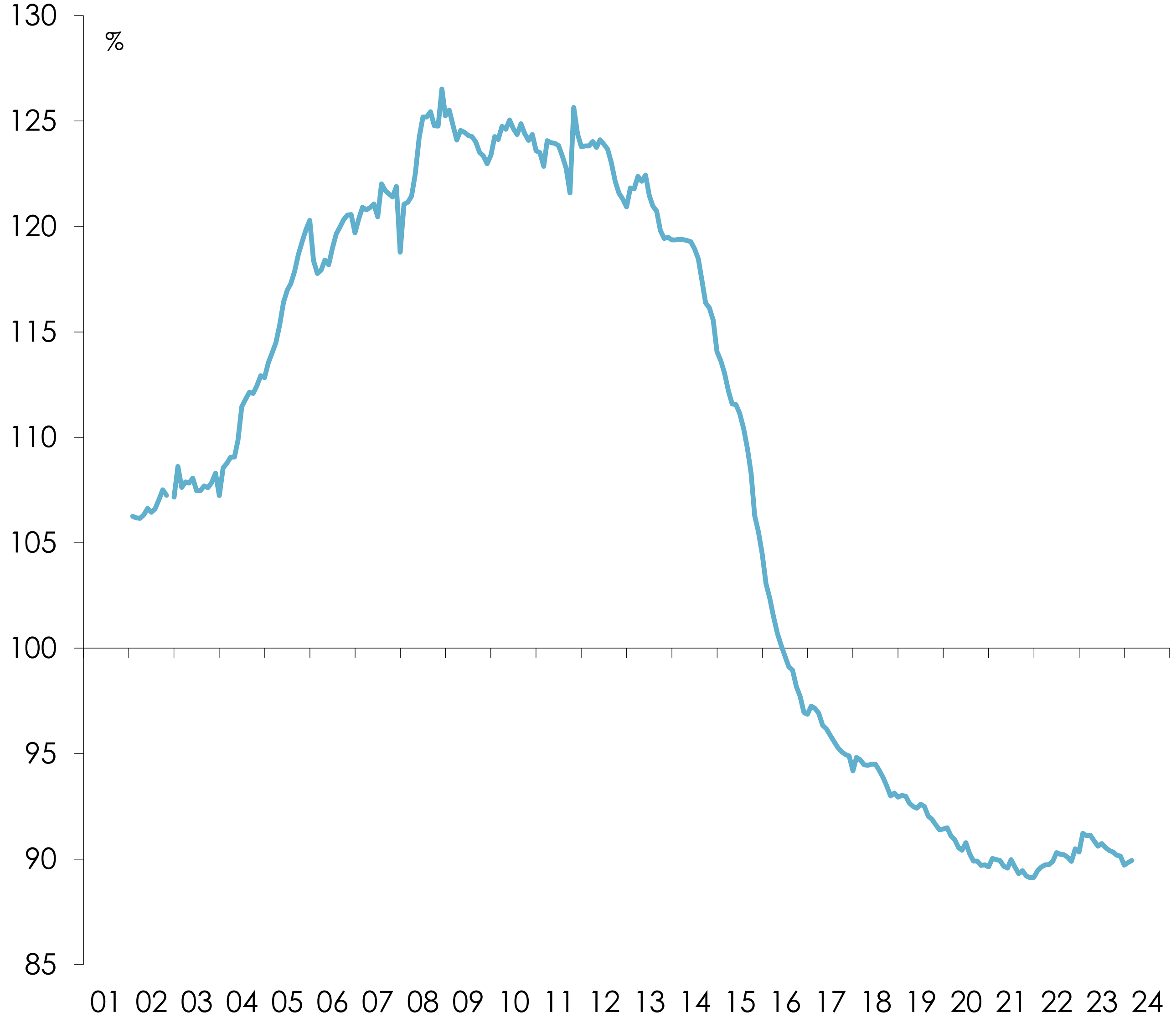
One possible prompt for large capital outflows, and hence a big fall in the renminbi, could be revelation of large loan losses at Chinese banks

Chinese banks' non-performing loans



Loan-to-deposit ratio of Chinese banks



Source: China National Financial Regulatory Administration; People's Bank of China.

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China's financial regulators appear to be taking a tougher line on 'pretend and extend'

China's banks have a bad-debt problem

As is becoming increasingly obvious

BANK OF JIUJIANG, a mid-tier lender from a southern Chinese river town, imparted some bad news on March 19th. In a rare disclosure, it told investors profits for 2023 might fall by 30%, because of poorly performing loans. This is just the sort of information Chinese banks are normally reluctant to reveal. Indeed, they often go to great lengths to avoid doing so.

Typically, the subterfuge works as follows: the bank lends to an asset-management company (AMC) that in return purchases its toxic loans. The contracts drawn up between the two parties include stipulations that enable the AMC to avoid the credit risks of the bad loans they are buying. Confidentiality clauses keep these arrangements from being disclosed, sometimes even to courts.

The authorities are now catching on. They have hit financial institutions with a flurry of penalties for improper handling of debts. The National Administration of Financial Regulation (NAFR), a new banking regulator, has handed out more than 20 punishments. In December Citic Bank, a commercial lender, was fined 220m yuan ($30m) for mismanaging bad debt, a record amount. Agricultural Bank of China, a large state lender, received a 27m yuan fine for similar transgressions.

Increased surveillance can in part be attributed to the new watchdog's increased vigilance. Established last year, the NAFR has stronger enforcement capabilities than its predecessors. Supervision of banks had been divided among several agencies, allowing corruption and producing lapses in oversight, which contributed to the collapse of several banks, starting in 2019. The NAFR now seems to be taking the concealment of bad debts more seriously.

But some of the progress began earlier. A decade ago, instead of declaring the true size of their problems by identifying debts as "non-performing loans", banks shoved them into other categories of assets, signalling to regulators that there remained a good chance borrowers would repay (in fact, many of the companies had gone bankrupt). In 2017 one of the NAFR's predecessors began leaning on lenders to be more truthful. The result has been an outpouring of undesirable loans. Bank of Jiujiang's bad loans, for instance, increased seven-fold between 2015 and late last year.

How much of this surge in activity can be trusted? Recognising and digesting bad debts is difficult. Discovering such lending weakens financial institutions' balance-sheets since they are forced to use capital to provision for future bad debts, which in turn makes it harder for the government to direct financial support to favoured industries in pursuit of other policy goals. Some revelations will happen legitimately as local governments recapitalise banks, pumping in funds to enable them to continue to write off bad debts.

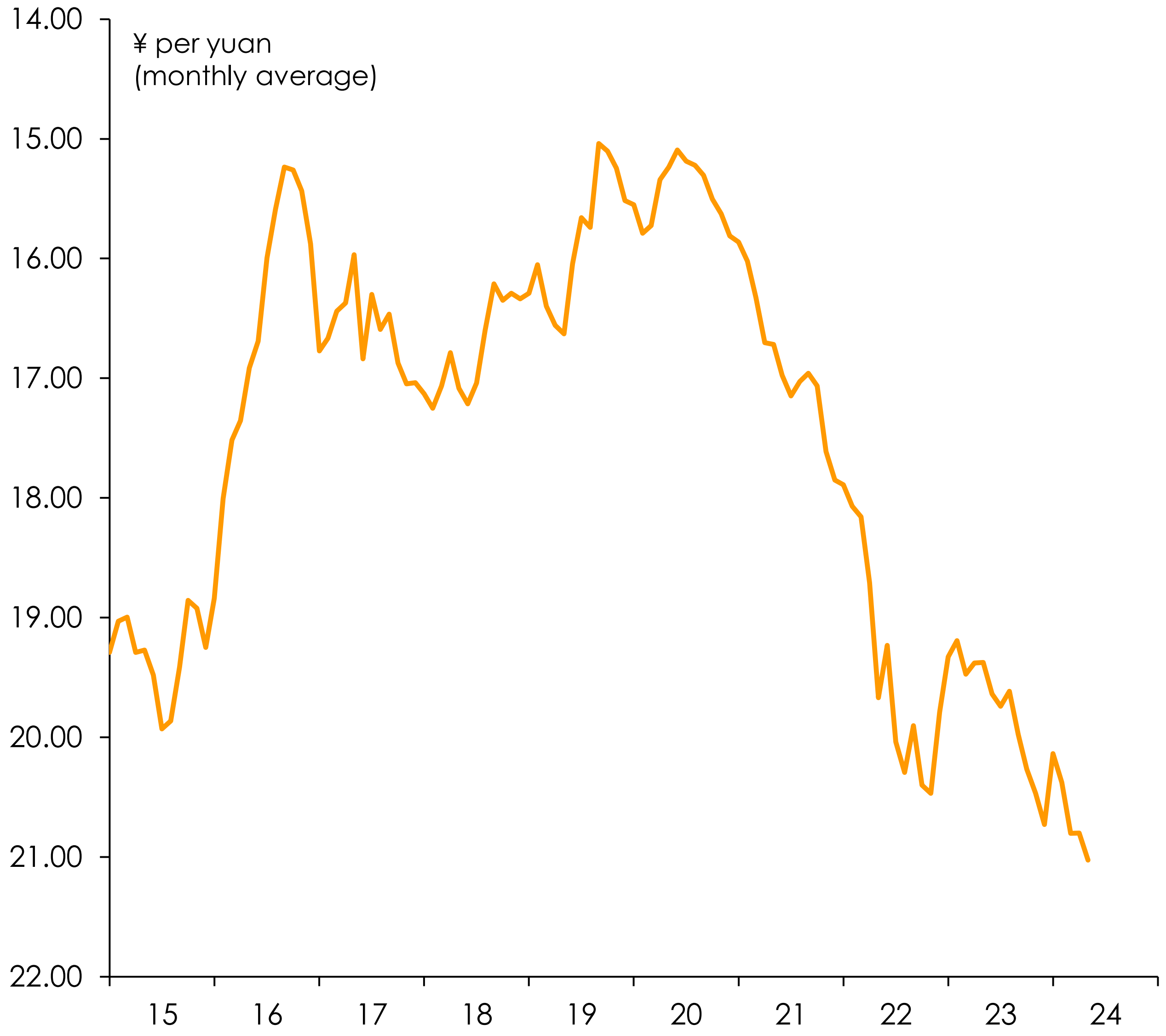
Others will happen via AMCs, and thus will only sometimes be legitimate. China created four centrally controlled AMCs decades ago to hoover up bad debts. They are now struggling. One needed a $6.6bn bail-out in 2021. Others are poorly capitalised and as a result buying fewer and fewer bad debts, even as banks crank out more. In 2016 the four state AMCs bought nearly 1trn yuan of about 1.5trn yuan in total non-performing loans. By 2022 their purchases came to less than 500bn yuan, despite bad debts rising to almost 3trn yuan.

In late January state media reported that three of them would be merged with China's sovereign wealth fund. They have become distressed financial institutions in their own right and can hardly perform the debt clean-up work for which they were created. That is bad news for Bank of Jiujiang. It is also bad news for hundreds of other similar lenders. ■

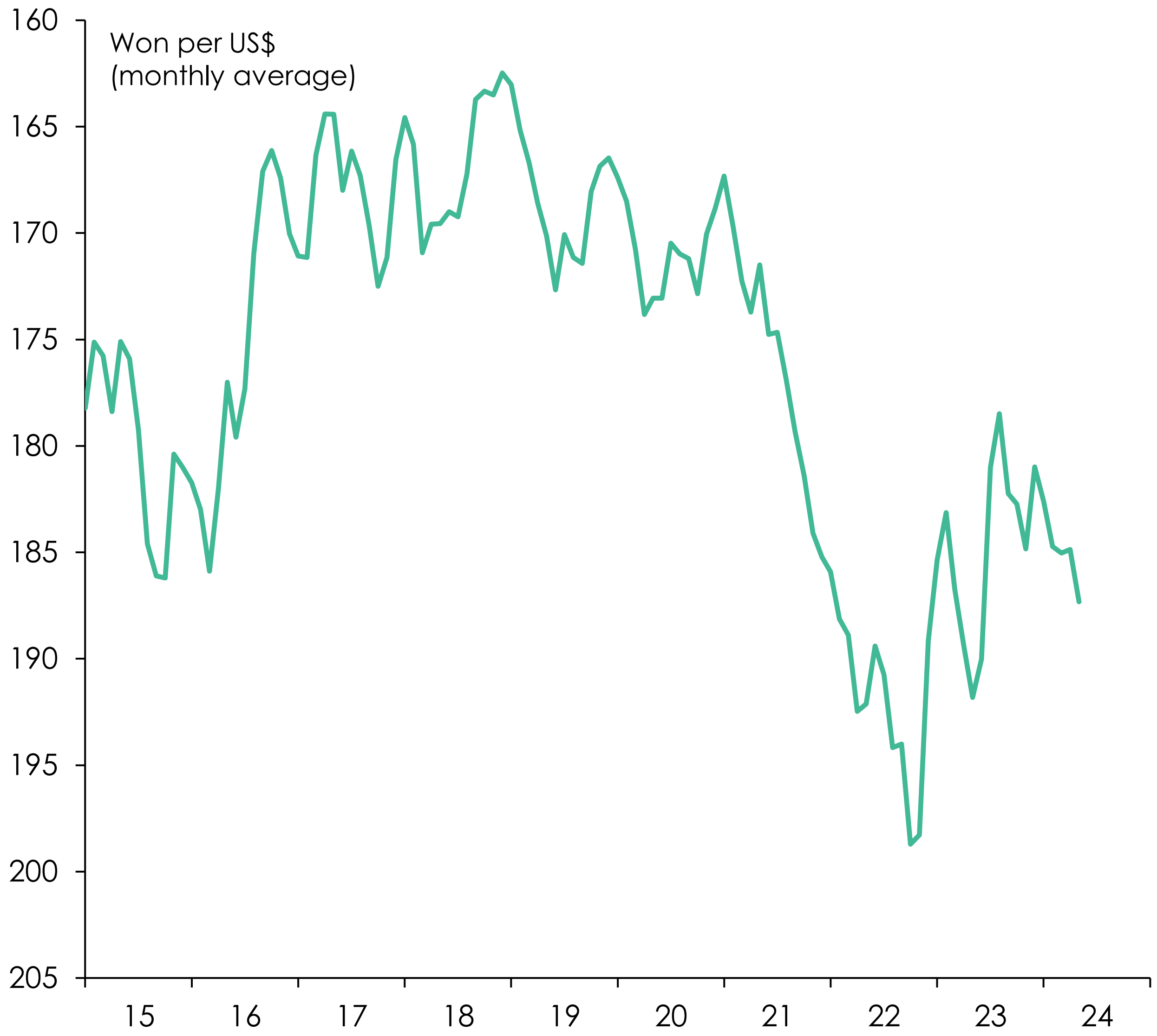
Source: The Economist, 27th March 2024.

The 'Chinese authorities' may be displeased at the weakening of the yen and (to a lesser extent) the won against the yuan

Yuan vs Japanese yen



Yuan vs Korean won



Source: LSEG Refinitiv Datastream.

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Conclusion

- China isn't going to have any sort of currency crisis in the very near term
  - it is still running current account and 'basic' balance surpluses
  - and it has substantial official FX reserves (equivalent to 16 months' imports)
  - and state-owned commercial banks may also be holding additional FX reserves 'on behalf of' the PBoC
- China is not in the same position as Thailand, Malaysia, Indonesia, Korea, or the Philippines in the mid-1990s
  - its banks and corporates haven't been borrowing unhedged in foreign currencies
  - and their reserves were down to less than 4 (or in some cases 3) months' imports ahead of the mid-1990s crisis
- However China does in some ways resemble Japan in 1998, when it had a banking and currency crisis despite running current account surpluses, having large FX reserves and being an international creditor
  - Japan's 1998 banking and currency crisis was triggered by the revelation of large loan losses at banks arising from the collapse of Japan's property market bubble at the end of the 1980s and from foreign currency loans in Asia
- China's current account and/or its basic balance could slip into deficit over a (say) 3-5 year horizon
  - in which case the large 'overhang' of domestic money and credit relative to its FX reserves could prompt 'capital flight'
- A 2019 IMF Working Paper noted that "Chinese residents are not used to regular two-way movements in the exchange rate and hence their expectations are more sensitive to signals of change" and that they "exhibit herding behaviour in response to shocks"
  - "a large pool of [renminbi]-denominated savings is held by residents … and there are insufficient domestic assets in which to invest … Chinese residents' demand for foreign assets is suppressed by [capital controls] and even a small fraction of households switching to foreign assets could lead to sizeable capital outflows"
- It's also possible that the 'Chinese authorities' could decide to trigger a large renminbi devaluation as a means of promoting stronger economic growth ('if all else fails')

Important information

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