China Economic Perspectives

Do the Facts Support the Super Bears?

Economics

China

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Being bearish on China is almost consensus and understandable

Chinese economy faces serious challenges: the economy has been slowing for a few years due to both structural imbalances and cyclical factors and notwithstanding continuous policy support; a deep property adjustment and excess capacity issues have led to deflationary pressures, a sharp deterioration of corporate balance sheet, and rising debt burden. It is well understood that China's rapid increase of leverage has brought serious potential losses to the banking system which would require years to clean up. Despite still sizable current account surpluses, the RMB is facing serious depreciation pressures, partly driven by persistent capital outflows against rapidly falling FX reserves.

The latest super bearish view

Against the background of a general weak sentiment on China, some super bears are now expecting an imminent collapse of China's banking system and currency. The latest super bearish view goes like this: 1) the RMB has appreciated by over 40% and become significantly overvalued on a real effective basis, requiring a huge depreciation to correct China's imbalances; 2) the rapid credit expansion of the Chinese banking system will result in unprecedented losses which requires an immediate large bail out; 3) China would need to use FX reserves or embark on major QE to recapitalize its banks; and 4) China's official FX reserves include CIC holdings and policy bank recap funds, and are already inadequate.

We think the facts do not support a super bearish view

While we acknowledge the seriousness of challenges facing the Chinese economy and exchange rate regime currently, we do not think it as bad as some believe because: 1) the RMB appreciated from an under-valued position and we believe is only modestly over-valued, and China has no intention to risk destabilizing domestic and global markets by using a sharp depreciation to promote exports; 2) Banking sector losses should be derived from bad banking credit rather than total system assets, which would be much smaller than as currently expected by some. More importantly, banks have ample liquidity and do not have to recognize bad debt all at once, and do not require an immediate large capital injection; 3) China does not need to use FX reserves to recapitalize banks nor follow the US approach. Fiscal policy can and will continue to play a bigger role for supporting growth, and we believe the state will help recap the banks directly when necessary instead of beating around the bush; and 4) China's $3.2 trillion in FX reserves do not include CIC assets (much of it actually from capital gains) or bank recap funds. IMF's composite metric suggests that China needs $2.7 trillion in FX reserves without capital controls to defend against shocks and attacks – but China has capital controls and can implement them more strictly.

Our baseline: the muddle through

We expect the economy to continue to slow and corporate balance sheet to worsen. However, we see the risk of an immediate systematic financial crisis as very small, due to high domestic saving and ample banking liquidity, extensive government ownership of banks and many debtors, and capital controls. The above will enable slow recognition of NPLs with banks continuing to lend to the economy while raising more capital to help speed up debt write-off's over time. Notwithstanding serious depreciation pressures, we expect the RMB exchange rate to depreciate modestly with the help of persistent current account surplus, tighter capital controls and some loss of reserves.

Most market participants are quite bearish on China at the moment, given the recent economic and policy developments. Chinese economy does indeed face serious challenges: The economy has been slowing for a few years due to both structural imbalances and cyclical factors and not notwithstanding continuous policy support; a deep property adjustment and excess capacity issues have led to deflationary pressures, a sharp deterioration of corporate balance sheet, and rising debt burden (China Outlook, Property Bubble Trouble, Bubble Trouble: Halfway Through?); and it is well understood that China's rapid increase of leverage has brought serious potential losses to the banking system which would require years to clean up. Despite still sizable current account surpluses, the RMB is facing serious depreciation pressures, partly driven by persistent capital outflows against rapidly falling FX reserves.

Notwithstanding these challenges, our baseline scenario is for a muddle through, with China continuing to use fiscal expansion to support growth; monetary and credit conditions being kept adequate with the help of RRR cuts, moral-suasion and capital controls against the backdrop of high domestic savings; banks continuing to lend while raising more capital to help speed up debt write-off's over time, both helped by extensive government ownership; and the government accelerating corporate and debt restructuring in the next few years. Notwithstanding serious depreciation pressures, we expect the RMB exchange rate to depreciate modestly with the help of persistent current account surplus, tighter capital controls and some loss of reserves (see The Most Asked Questions about China, The Big Picture Bottom-line, The Outlook). There are of course downside risks to our muddle-through scenario, particularly if cross-border capital flows are not well controlled and/or PBC remains too hawkish while corporate restructuring takes place too slowly.

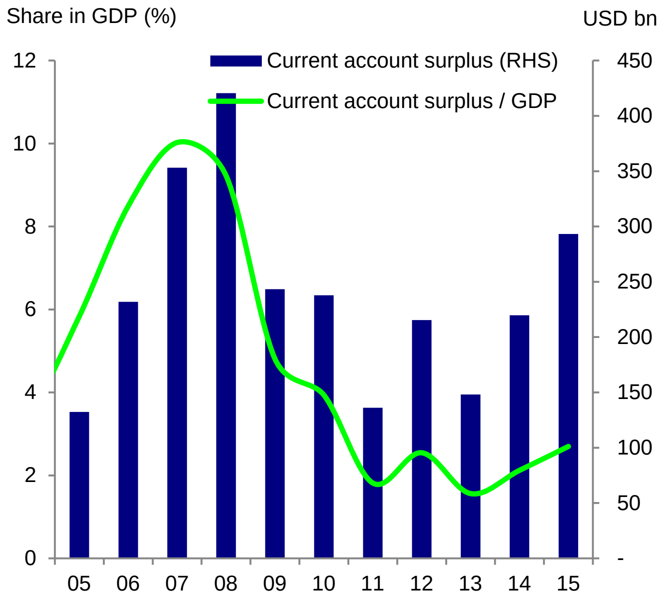
Here is where we think the facts do not support a super bearish view:

Point one: the exchange rate is significantly over-valued and a large depreciation is warranted to solve the domestic growth problem. This view believes that because its real effective exchange rate has appreciated by over 40% since the global financial crisis, China needs a dramatic devaluation to regain export competitiveness, something the Chinese government will soon implement.

While the RMB has appreciated significantly in the past few years, it started from an under-valued position and China has also seen faster productivity gains compared with its trading partners. That is why despite the big adjustment in exchange rate and external balances, China still had a sizable current account surplus in 2013, before the sharp decline in oil and commodity prices made the surplus even bigger (Figure 1). It is true that RMB appreciation may have overshot in the past two years as the USD appreciated against currencies of China's major competitors. However, the IMF thinks the RMB is close to its fair value and we estimate that RMB real effective exchange rate is only 5-10% over-valued (Figure 2).

Also, as we have written earlier (Why and what you need to know about CNY, What Next for the RMB?, Trade Data & CNY), there are other important reasons why China may not want to use currency depreciation to help solve its economic woes: As the second largest economy and biggest exporter, depreciating the currency sharply will likely lead to even larger depreciation of many competitor currencies, which may destabilize global markets with limited benefit to China; the government is also concerned that a large depreciation may lead to panic outflows that could destabilize expectations and domestic financial markets; while depreciation can help exporters, it is questionable that all of it will be passed on by exporters to their selling prices or how much any subsequent export improvement can help alleviate the real drag on Chinese growth from excess capacity in much of the heavy industrial sector.

Figure 1: China has sizable current account surplus



Source: CEIC, UBS estimates

Figure 2: 2014 RMB REER assessments

	Approach	Desired CA adjustment (% of GDP)	Desired REER change (%)
IMF	Current Account Panel Regression	-3 ~ -1	3~12
	The REER Index Model		6.5
	The REER Level Model		-6.8
PIIE	Macroeconomic Balance Approach	none	none
UBS	Macroeconomic Balance Approach	0.5-0.9	-1.8~-3.3

Note: Using 2014 data, both the IMF's 2015 staff report and the Peterson Institute of International Economics (PIIE) found that the RMB was no longer under-valued. Our estimate suggested a similar result. RMB real effective exchange rate appreciated by 10% on average in 2015 vs 2014, and by 4% at end 2015 vs end 2014, despite a modest depreciation against USD by 5% during the same period.

Source: IMF, PIIE, UBS estimates

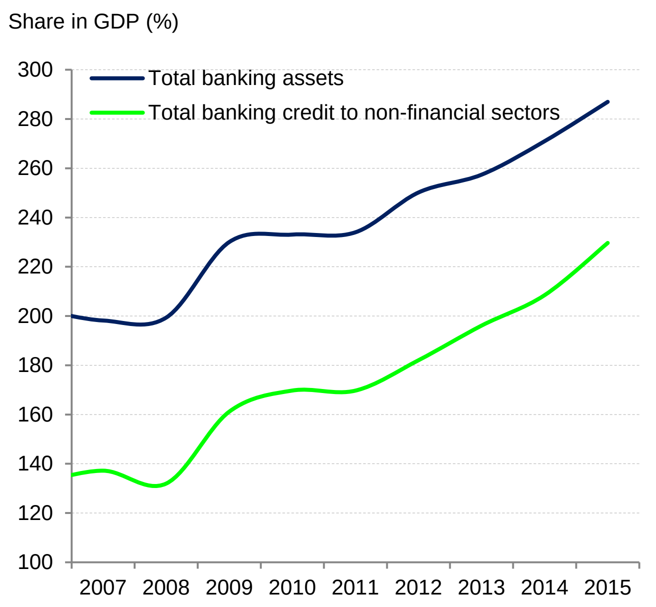
Point two: China's banking sector is 340% of GDP, 10% loss would be over 30% of GDP or more than $3.5 trillion, which would require an immediate and large bail out.

It is true that China's credit has expanded rapidly since the global financial crisis, mainly in the form of bank loans and off-balance sheet bank credit, and China's banking system is the largest in the world – almost 290% of GDP at end 2015 (Figure 3). We have written extensively on the issue of unsustainable trend of leverage increase, likely much larger bad debts, and the need to take decisive action to avoid a debt-deflation trap (The Most Asked Questions about China, China 2016-2017 outlook, China: Hello Minsky?, How Bad Is China's Debt Problem?). However, banking sector assets also include bank reserves kept at the central bank and substantial inter-bank assets. We estimate that overall bank sector credit to all non-financials, including both loans and off-balance sheet credit such as commercial bills and all trust assets stood at about 230% of GDP in 2015, of which more than 50% was to the government and about 140% to the corporate sector. Therefore, even a 10% NPL with zero recovery would still lead to a much smaller loss than suggested in a super bearish scenario.

While Chinese banks may indeed incur substantial losses over time from bad debts and some losses may have started to emerge already, they do not require immediate large recapitalization. China's banking system still enjoys ample liquidity –

the most important thing for banks – in the form of cheap deposits thanks to a high saving rate and under-developed financial markets. The Chinese government has extensive control and ownership over/of banks as well as SOE and local government borrowers, and has always made depositors whole. These combined factors mean that recognition of non-performing loans will be slow, banks and debtors will be asked to renegotiate and restructure debt rather than engage in a rapid write-off. We expect banks to gradually raise capital through various means (policy banks, accounting for about 10% of financial system assets, have already received government recapitalization in 2015), but do not see the need for a large bail out immediately.

Figure 3: China's credit has expanded rapidly since GFC



Source: CEIC, UBS estimates

Point three: China needs to use FX reserves or print more than $10 trillion to recapitalize its banking system. As the US Fed had to use massive QEs to help banks raise $650 billion in capital, the PBC would need to print more than $10 trillion worth of RMB to help recapitalize China's banking system.

There is a common misunderstanding that China needs to use FX reserves to recapitalize banks. Actually, it does not. Although China has done so more than once before, it was for other reasons such as bypassing lengthy legislative (National People's Congress) procedures to speed up bank reform and listing (Does China Have Enough FX Reserves?). Back in 2003 and 2005, when big state banks received FX reserves as capital, PBC exchanged its foreign assets with state banks' equity shares (through Huijin). So PBC's FX assets declined and its domestic equity assets increased. Later, the Ministry of Finance (after NPC approval) bought these equity shares from the PBC with special government bonds. The PBC's domestic assets (claims on the government) thus increased while its equity assets declined. When Chinese banks receive FX reserves as capital, they actually need to exchange it for RMB as their lending is predominantly in RMB. That is exactly what happened to the recapitalization FX – which later ended up back on the PBC's balance sheet as FX assets. **In the end, all that changed in the PBC's balance sheet was an increase in claims on the government on the asset side, and an increase in money supply on the liability side, with no net impact on FX reserves.** Of course, having large FX reserves are useful in dealing with capital outflows and shoring up confidence in the context that recapitalizing banks leads to more monetary easing and outflows.

On the second point, China does not have to take the US Fed approach to bank recapitalization. First, the Fed's multiple rounds of QE arguably are mainly aimed at reviving the economy in the absence of major fiscal stimulus. In the case of China, fiscal policy has and will likely continue to take a bigger role in supporting the economy. Second, unlike their US counterparts, Chinese banks are mostly owned (or majority owned in the case of listed banks) by the government, which

will likely participate in any recapitalization, and there is no ideological qualm about that either. Therefore, if banks need X amount of capital, China's government can directly inject X amount less market/corporate participation into them – instead of beating about the bush and flooding the market with liquidity at multiples of the required amount. Here it is also important to note that the government's balance sheet is in reasonable shape (even after taking into account local government debt and other contingent liabilities, total government debt to GDP ratio is about 60% of GDP) and can help with recapitalizing banks if needed.

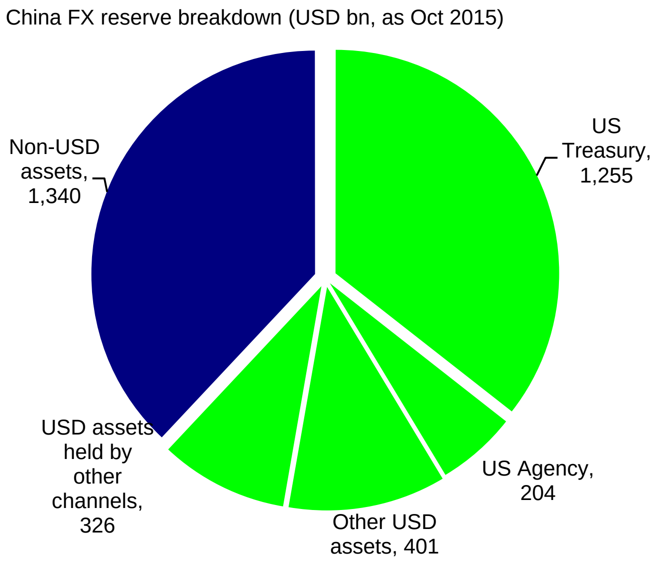
Point Four: China's useable official FX reserves are much less than $3.2 trillion after excluding holdings of sovereign wealth fund assets and money used to recapitalize banks, and are already below what IMF considers adequate.

First, typically FX reserves are used to cover balance of payment transactions, such as short-term debt obligations and import bills. From that perspective, China has more than enough (see details in Does China Have Enough FX Reserves?). Taking into account a country's need **to defend against shocks and attacks**, analysts sometimes use more money-based indicators to measure reserves. Based on the IMF's composite metric, which takes into account capital outflows, **China would need $1.5 trillion in reserves with capital controls and $2.7 trillion without controls** as of end-2015. Obviously, **China still has capital controls**, even if they are somewhat porous. This means the required FX reserve level for China should be somewhere in between the two figures, depending on how much controls China can and plans to exercise.

Second, **current official FX reserves of $3.2 trillion do not include CIC assets or bank recap funds.** When CIC received its first $200 billion in 2007, the accounting was very clear – Ministry of Finance issued special bonds of the equivalent amount in exchange for the FX reserves PBC had provided, including those used for recapitalizing the big banks. So the PBC's balance sheet saw its FX assets decline and domestic assets (claims on the government) increase. Since then, CIC has reportedly received other FX transfers over the years, but well below $100 billion in total. What about the roughly $700 billion in total assets now at CIC? More than $400 billion are domestic assets, most of which are capital gains made from its equity holdings of domestic financial institutions. Indeed, some of its over-$200 billion in overseas investments was also accrued via capital gains and investment income. As for the more recent recapitalization of Chinese policy banks, and the Asia Infrastructure Investment Bank and Silk Road Fund, these funds have also been deducted from FX reserves, though the accounting is more convoluted than in the case of CIC (What Investors Should Know about China's Capital Outflows). One thing remains clear however, **until recently, China had consistently faced a challenge of capital inflows and appreciation pressure, which therefore saw the government encouraging outflows and diversifying FX assets away from official reserves into other forms of investment**. In other words, official FX reserves under-represented China's useable foreign assets, which were either listed as "other foreign assets" on PBC's balance sheet or held on the balance sheets of other entities.

As we have written earlier (Why and what you need to know about CNY, and Does China Have Enough FX Reserves?), more than $2 trillion of China's official reserves were held in G-10 government bonds, of which more than half is in US treasuries, with the rest of the $3.2 trillion held in US agency debt, overseas equity, corporate bonds and various other assets, including through third party money managers (Figure 4). As we have cautioned, which assets are considered liquid in a traditional sense may not apply to China because of the enormous size of its holdings. Perhaps more importantly, we believe China will not rely solely on FX reserves to defend currency stability or fend off market pressures. As Governor Zhou confirmed in a recent interview, we believe China will use both tighter capital controls and increased exchange rate flexibility as well (Governor Zhou Speaks on RMB and Capital Flows).

Figure 4: Composition of China's official FX reserves



Source: US Treasury TIC annual survey, UBS estimates

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