Statement before the Senate Committee on Banking, Housing, and Urban Affairs
On Evaluating the Financial Risks of China

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July 14, 2016

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Thank you Chairman Shelby, Ranking Member Brown, and members of the Committee for affording me the honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent the AEI's view on the subject under discussion.

Introduction

The Chinese economy, which is now the world's second largest economy and the world's largest trading nation, has become highly imbalanced as a result of an excessive reliance on credit creation and on investment-led growth. As a result, China's economic growth model is now showing every sign of having run its course. This has prompted the Chinese government to recognize the need for more balanced economic growth and has led it to significantly mark down China's long-term economic growth forecast.

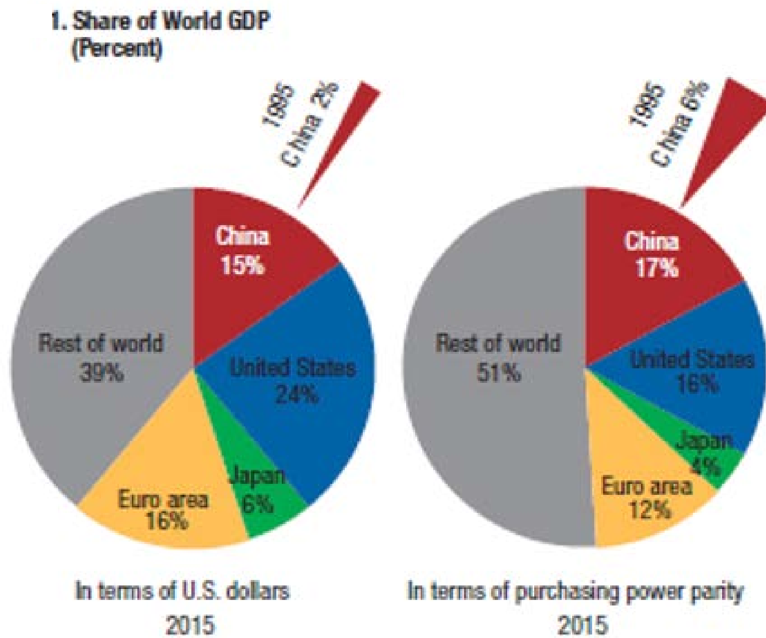
It would be a mistake for US policymakers to minimize the large adverse impact that a further slowing in the Chinese economy could have on the US

economy. Since a change in the economic fortunes in China could have a strongly adverse impact on the world economic outlook and on global financial markets. This would seem to be especially the case at a time that the world economy is drowning in debt and at a time that it is confronted with an unusual confluence of material downside risks. These latter risks include those emanating from last month's Brexit referendum, from the Brazilian economic and political crisis, and from the serious weaknesses now being revealed in the Italian banking sector.

China's growth model has become increasingly unbalanced

In assessing China's potential to impact the US economic recovery, it is well to recall how important China has become to the global economy. Through two decades of very rapid, albeit unbalanced, economic growth, China's share in the world economy has increased from 2 percent in 1995 to 15 percent in 2015. This has made China the world's second largest economy ahead of Germany and Japan. In recent years, China, together with the other large emerging market economies, has been the principal engine for world economic growth. It was also a major factor in the super-international commodity price boom between 2008 and 2013, which drove strong economic growth in the world's major commodity exporting economies.

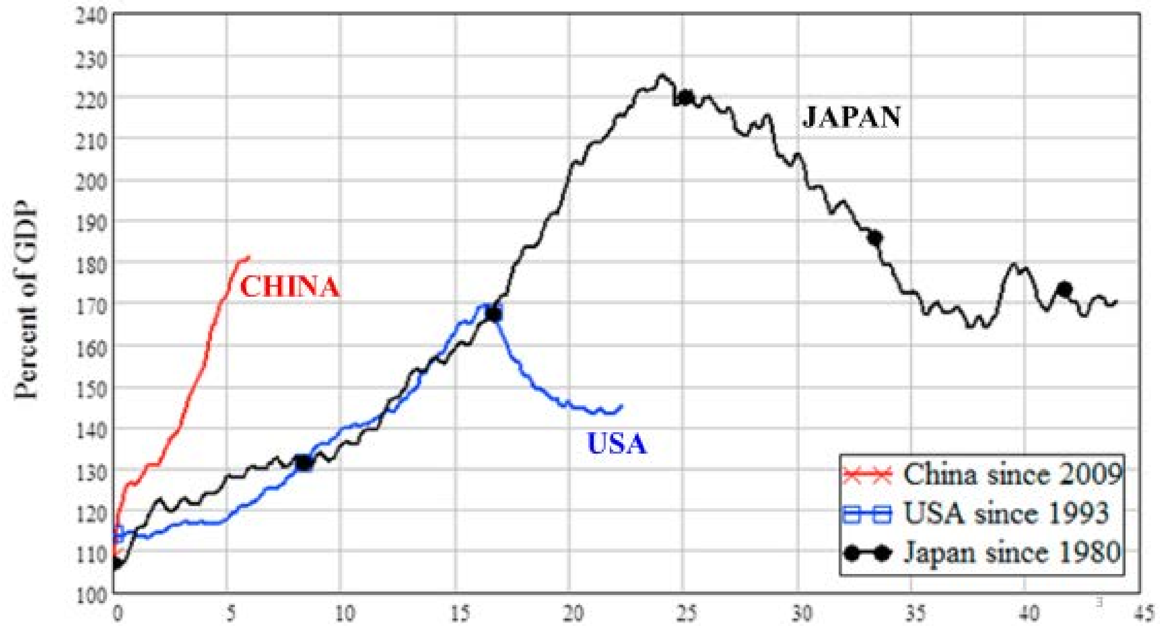
Figure 1: China's Role in the Global Economy



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

A primary concern about the Chinese economy is that it has relied excessively on an unbalanced and unsustainable economic growth model to drive its rapid economic growth. The unbalanced nature of the Chinese economy is most apparent from the fact that Chinese investment accounts for around 45 percent of China's GDP. It is also apparent from the fact that China has relied excessively on credit creation from its banking and shadow banking systems to drive economic growth and investment. Indeed, since 2009 Chinese credit to the non-financial private sector has increased by around 90 percent of China's GDP. Such a rate of credit expansion has been very much more rapid than that which preceded Japan's lost decade in the 1990s and that which preceded the US housing bust in 2007.

Figure 2: Private Debt Bubbles



Source: BIS, IMF

The excessive degree of Chinese investment and credit creation has given rise to a tremendous misallocation of resources. Many sectors of Chinese industry, including most notably the steel and construction sectors, are now characterized by massive excess capacity. In addition, excessive credit creation has spawned bubbles in the Chinese property and equity markets. Those excesses are now apparent in ghost towns and see-through commercial properties in many Chinese second-tier cities.

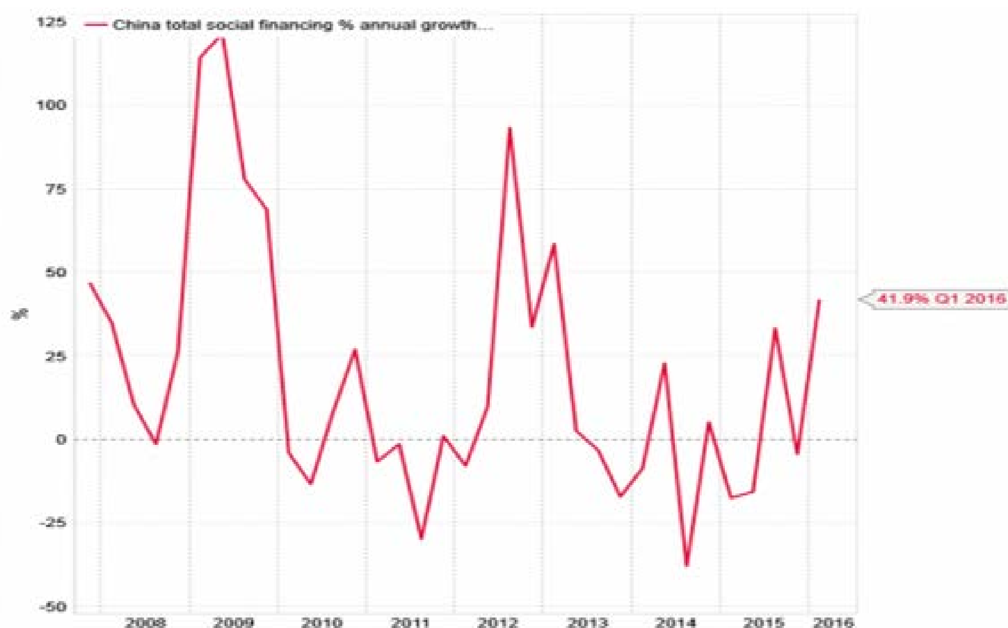
As the excesses in China's economy have started to be unwound, Chinese economic growth has slowed markedly from its former double digit rates. According to Chinese official estimates, real Chinese GDP growth has now slowed to below 7 percent and is expected to remain between 6 ½ and 7 percent over the next few years. However, many respected private sector analysts estimate that the Chinese economy may have already slowed to around 4 percent. Those analysts are justifiably fearful that China's economic growth will remain low as it transitions to a more balanced economic growth model.

Delaying Reforms

The present Chinese Administration appears to fully recognize the imbalanced nature of the Chinese economy and of the need to promote economic reforms that might make China a more consumer and service driven economy. To that end, the Administration has vowed to rebalance demand and to eliminate China's debt

addiction before the country reaches its debt capacity limits. It has done so with the goal of achieving a more balanced and sustainable economic growth model.

Figure 3: Borrowing in China is growing fast again



While President Xi Jingxing's administration has adopted certain measures towards reforming the economy, it is far from clear that it is fully committed to addressing China's credit addiction and to curbing its shadow banking system. Indeed, official data reveal that, in response to a slowing Chinese economy, the People's Bank of China has permitted yet another burst of credit as reflected in a more than 40 percent increase in such credit for the first quarter of 2016. More recently, however, Chinese credit growth appears to be being reigned in again.

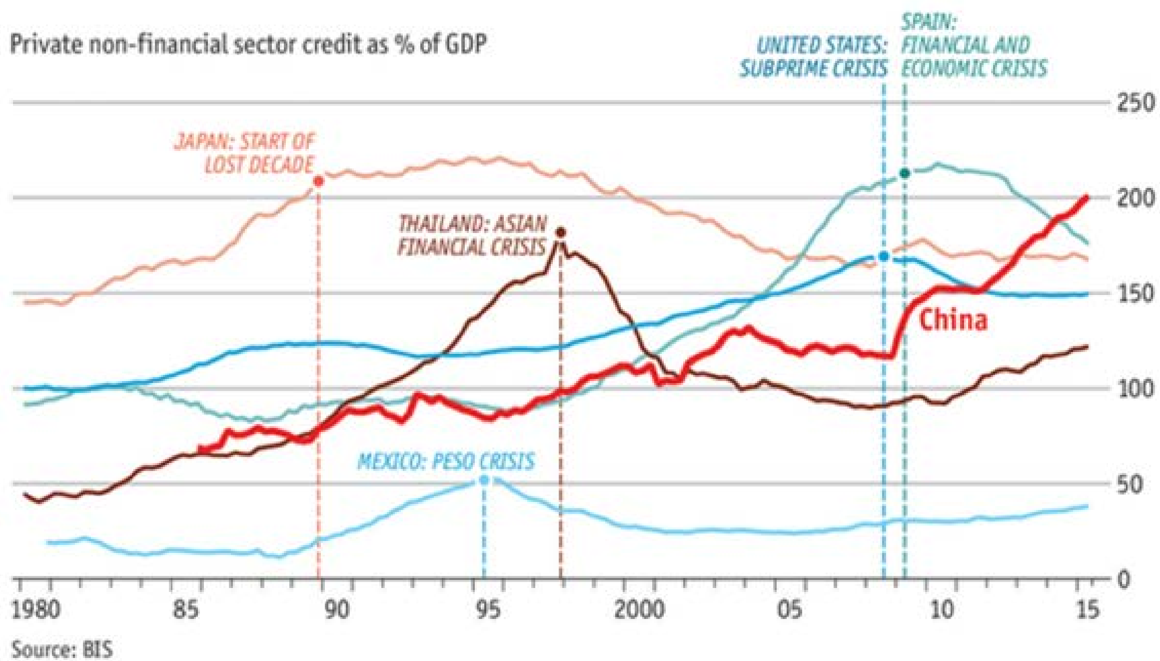
Precedents from other credit bubbles

The extraordinary increase in Chinese private non-financial sector credit over the past eight years has been at a pace that exceeds those that have preceded other major economic and financial crises. These crises include Japan's lost decade in the

Source: Macrobond, The Independent

1990s, the Mexican peso crisis in 1994, the Thai financial crisis in 1997, and the US housing bust in 2007. Those earlier crises would all suggest that the current Chinese credit bubble will not end well and that the world should brace itself for a prolonged period of relatively slow Chinese economic growth.

Figure 4: Comparable Credit Bubbles



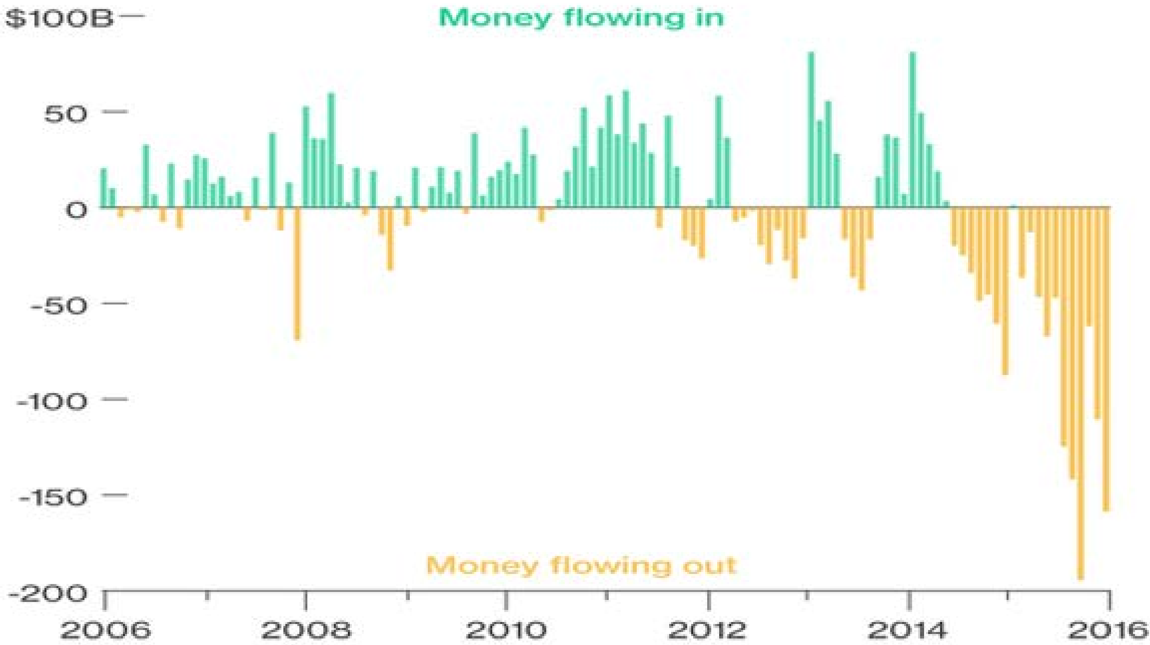
The fact that China's banking system is dominated by four state owned banks makes it unlikely that China will experience an abrupt credit event like that which occurred in Asia during the late 1990s or in the United States in 2008. Rather, what is more likely is that the Chinese banking system will become increasingly clogged with non-performing loans and with loans to zombie Chinese public and private sector companies along the lines that has occurred in Japan over the past two decades. This is very likely to keep China on a very low growth path for an extended period of time.

China's capital flight problem

Beyond the prospect of a slowing domestic economy, China's present capital outflow problem could pose a further risk to the global economy. During 2015,

private capital outflows from China amounted to almost US$700 billion in the wake of China's decision to move toward a more flexible exchange rate in August 2015 and of the correction of China's equity and property market bubbles. While China still has more than US$3 trillion in international reserves, it is clear that China cannot sustain its recent pace of capital outflows for too long a period.

Figure 5: Chinese Capital Flows



Source: BIS, Institute for International Finance

Over the past few months, capital outflows from China have moderated as capital controls have been tightened and as the Chinese currency has stabilized. However, there is a considerable risk that China may feel obliged to again weaken its currency to stimulate export growth particularly in the context of a rising US dollar in the wake of the Brexit vote. The experience of August 2015 would suggest that any significant move to a more depreciated renminbi against the US dollar could again renew capital outflows.

Implications for the United States economy

It would be a mistake for US policymakers to minimize the large adverse impact that a setback in the Chinese economy could have on the US economy. Since a change in the economic fortunes in China could have a strong impact on the world economic outlook and on global financial markets. This would seem to be especially the case at a time that the world economy is drowning in debt and at a time that it is confronted with an unusual confluence of material downside risks

In assessing the financial and economic risks from China, it is important to distinguish between the direct and indirect impacts that a slowing in the Chinese economy might have on the US economic outlook. In that respect, it would seem that a further Chinese economic slowing should not have a material **direct effect** on the US economy. After all, China accounts for only around 7 percent of total US exports or less than 1 percent of US GDP. Similarly only 2 percent of US enterprises' net income is derived from China while US bank exposure to China only amounts to around 1 percent of the US banking system's balance sheet.

By contrast, the US economy could be **indirectly** affected in a major way by a further Chinese economic slowing through the effect that such a slowing might have on the rest of the world economy and on global financial markets. This might occur through three distinct channels:

a. First, a slowing in the Chinese economy would have a significant impact on the exports of China's Asian trading partners and of countries like Germany, which are very much more dependent than is the US on the Chinese economy for their exports. As such, it could materially affect the global economic outlook confronting the United States.

b. Second, China might be forced to make use of its exchange rate to bolster its flagging economy especially if it continues to suffer from capital outflows. This could result in tensions in global currency markets where all too many countries are seeking to cheapen their currencies.

c. Third, a slowing Chinese economy must be expected to keep international commodity prices low for a protracted period of time. This has the potential to deepen the political and economic crises already being experienced in major commodity exporting emerging market countries like Brazil, Russia, and South Africa.

Two further considerations would argue that there should be no room for complacency in US policymaking circles about the Chinese economic outlook. The first is that the three channels by which China could affect the global economy are all too likely to play out simultaneously. That would only amplify their negative impact on the global economy. The second is that a further Chinese economic slowdown could trigger other major fault lines in the global economy in countries like Brazil, Italy, Japan, and Russia. That too would argue against being overly complacent about potential Chinese economic developments at this delicate juncture in the global economic cycle.