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MARKETS INSIGHT

Beijing must learn from other financial crises – and act fast

Bill Rhodes

My involvement in financial crises over several decades has taught me that the longer governments wait to take tough decisions the more difficult it is to stem the tide and curb the ensuing increase in losses.

China's leaders now need to recognise this reality as they confront escalating risks across the financial landscape. Further delay in acting boldly will undermine domestic and international confidence in their economic management skills: in the short term it will prompt increasing capital flight, while ensuring lower medium-term GDP growth.

Paul Volcker faced a major economic crisis when he took the helm of the US Federal Reserve Board in 1979. To curb roaring inflation he decided to confront the dragon with exceptional monetary policies. One consequence was a recession. But it was short, the dragon was slayed and the American economy was set on a sustainable and substantial growth path.

However, the forces for caution may prevail in Beijing right now. Prominent leaders have recently made a series of major public statements to suggest that the economy is in better condition than has widely been reported.

At the same time, it is possible that the leadership may want to delay any tough new measures before it is clearer that the economy can secure the sustained 6.5 per cent to 7 per cent annual growth target that Premier Li Keqiang has publicly promoted and which the leadership hopes will become China's new normal.

Markets may not respond kindly to the lack of tough action. China faces multiple problems in the finances of municipalities, provincial governments and state-owned enterprises (SOEs) — publicly held debt has been estimated to be about 230 per cent of GDP.

Official figures may be conservative in estimating distressed bank assets at Rmb1.27tn ($196bn). In addition, the country has bloated real estate and "shadow" banking sectors that are swimming in debt. I believe it is unsustainable for the People's Bank of China to keep on pumping cash into the system to keep all boats afloat.

There is a lot of talk of reducing significant amounts of the distressed assets through debt-for-equity swaps. This kind of approach was popularised in the Latin debt crisis in the 1980s and early 1990s. It may buy some time, but it is not a solution.

Securitisation schemes, which are widely under discussion, may also offer some respite, but the authorities have to recognise how large the problem is and confront it head-on. They must strive to write off as much of the distressed debt as possible. Major institutions must take the losses and some SOEs and "zombie" companies will need to be closed. The longer the delay, the greater will be the drag on the economy.

The leadership might learn from recent history and the effectiveness of the reforms promoted by former premier Zhu Rongji in the 1990s. He not only paved the way for China's entry into the World Trade Organisation, but he made banks increase capital and write off bad loans, with asset management companies established to acquire some of their distressed debts.

At the same time, he promoted substantial reforms to strengthen the balance sheets of SOEs, while also closing a number of inefficient ones. His actions played a major role in securing extraordinary economic growth year after year.

China's authorities have long understood that financial reform is necessary. For example, my conversations with former leaders prompted me to write a column for the Financial Times in 2005 that included suggestions for the deepening and broadening of domestic bond and equity markets. Meaningful measures are needed — resorting to official injections of funds to prop up the stock markets is not the way to go.

Not only are risks to the financial system at issue now, but indeed the consensus over far-reaching economic reform is being questioned increasingly. In 2013, it agreed on a reform course at the Third Plenum of the 18th Communist Party Congress, but it has been only partially implemented.

Interest rates have been freed up and the inclusion of the renminbi in the IMF's basket of Special Drawing Rights is a move towards currency convertibility. But far more needs to be done to modernise and liberalise financial markets, to boost domestic consumption and make the economy less dependent on exports.

The development of these reforms will be eased by debt write-offs and balance sheet clean-ups in the financial sector and in major SOEs, including the heavily indebted ones involved in coal and steel whose problems are compounded by overcapacity and slowing economic growth.

China's authorities should not delay in moving to secure confidence at home and internationally. Decisive action is essential.

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