China-US Business Alliance Luncheon

BY

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“Is China overdue for a Minsky Moment”? 

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I would like to thank AllianceBernstein, in particularly John Oden for inviting me to speak at the 8th anniversary of the China-US Business Alliance luncheon. I would like to dedicate my brief remarks here today to my friend, Tony Walton who passed away recently and who introduced me to this group and who also had a big interest in China. I have been asked to speak on the Chinese economy and will try to make my remarks as brief as possible in order to take questions as time permits, which is what you requested me to do.

The trade dispute between China and the United States is on everyone’s mind not only here but around the world. Much is at stake here, for the two largest economies in the world. However, the trade dispute is just one of several areas of possible conflict between the two countries, as there are a number of other differences including their political systems, economic models and potential strategic and military conflicts, such as, the South China Sea, and the one belt one road initiative which is so closely identified with President Xi Jinping of China. Often overlooked here is what really is the underlying strength of the present Chinese economy.

With this in mind, I have chosen as my topic, “Is China overdue for a Minsky Moment”? 
For those of you who are not familiar with the theory, the Minsky Moment is named after the late American economist, Hyman Minsky, whose theory was that a major sudden drop in asset values could generate a business cycle leading to a collapse in confidence, which would throw an economy into deep recession or depression. His theory became very much in vogue, at the time of the late great recession in 2007-2008. As it turns out, he was a professor of economics at Brown University at the time I was a student there, although I never got to know him personally because I was not interested in economics then as I was a history major and never thought I would end up as a banker.

The term Minsky Moment as it could possibly relate to China, was first raised most prominently by Zhou Xiaochuan the outgoing Governor of the People’s Bank of China (China’s central bank) on the side lines of the 19th Party Congress in November 2017. It was seen as a warning by a member of the reformist block in China who was very concerned about the excessive buildup of debt, which had reached nearly 300% of GDP and was still growing.

**China’s Debt**

One of the major reasons for this tremendous buildup of debt was the surge in borrowing from the shadow banking system which was largely unregulated at that time by financial supervisors. Additionally, there was an explosion in infrastructure debt by municipalities and provinces in China along with substantial over-lending in the real estate and housing area. Finally, and very importantly, there was a continuing splurge in borrowing by the SOEs (state owned enterprises), many of which are inefficient and should be closed down.

This was done in order to keep Chinese economic growth at the 7% level which had started to cause concern in 2015 when you had a substantial exit of Chinese capital and savings out of the country. In order to maintain the exchange rate of the Renminbi below 7 to the US dollar at the time, and to try to discourage further outflows, the PBOC lost ¼ of its reserves, which were reduced from 4
trillion to 3 trillion dollars, to support the currency over a period of approximately 12 months.

In addition, there was a major negative reaction in the Chinese stock markets and government owned financial institutions intervened to support the Shanghai and Shenzhen stock markets.

**Excess Lending**

At the time, President Xi Jinping and reformers around him, like Wang Qishan the Vice President and the PBOC, promised to ratchet back those areas of excess lending. Examples of this was their crackdown on some big Chinese conglomerates like Anbang, the HNA Group, and Dalian Wanda. The value of the Renminbi was stabilized and the loss of reserves was reversed. Unfortunately, three years later the efforts to curb the excess borrowing was later reversed to keep the GDP growth above 6%.

**U.S. Trade Concerns**

At the same time President Trump and those around him in the White House, critical of China, decided to correct those elements which they believed had allowed China to build up a big trade surplus with the U.S. by subsidizing Chinese companies particularly state owned enterprises in violation of the spirit and the regulations of the World Trade Organization, and by poaching our intellectual property and forcing our companies to transfer their technology to Chinese companies in order to operate in the country. They also accused China also of restricting US investments in many critical areas of Chinese industry and finance.

What people have to understand when they look at China, is that there are a number of senior reformers in the Chinese hierarchy who are disciples of former Premier Zhu Rongji, who was the most powerful and influential Premier in modern Chinese history since the days of Zhou Enlai. Following the opening up of China, by communist party leader Deng Xiaoping after the death of Mao Zedong, Premier Zhu Rongji, with the support of then President Jiang Zemin brought the Chinese economy into the modern world and made it into the power house economy that it is today.
He negotiated the entry of China into the WTO, the world trade organization, recapitalized the state-owned banking system which was over burdened by bad loans and a lack of capital. In the process of the latter reform, he allowed foreign banks to take limited participation in the Chinese state owned banking system and formed asset management companies to take over the bad loans of the banks, and was the first to start rationalizing and closing down some of the inefficient state owned enterprises (SOEs).

**China’s Growth in the 1990s**

The reforms of Premier Zhu Rongji, laid the basis for the tremendous economic growth in China in the late 1990s and early 21st century which allowed the country to have the financial ability to pump somewhere between 800 billion to a trillion dollars into the Chinese economy in 2008 and 2009 mainly in infrastructure projects which many feel saved the world from a great depression. Many Chinese including a number in the reformist block, feel the rest of the world including the US and Europe, underrated this effort that China made during this difficult world economic crisis.

This great injection of money was the origin of the tremendous buildup of Chinese debt which now needs to be brought under control to avoid a Minsky Moment in the future. The present trade war with the U.S. is exacerbating this situation and pushing the government to start a new round of stimulus, which it had promised to control after the 2015-2016 experience. How the Chinese leadership decides to manage this buildup of debt and still maintain its promised goal for economic growth will decide whether a Minsky Moment actually engulfs China in the near future and what the consequential fallout on the world economy will be.

**Actions Needed**

Finally, when I last spoke to this group in November 2017, I mentioned a series of steps that China needed to take to avoid a serious economic downturn and not surprisingly they are basically the same points that I have made today. I quote from my recommendations as follows:
• “China’s authorities need to take a series of actions that include: writing-off non-performing debts at banks and ensuring the recapitalization of some banks; bringing under rigid control the liquidity tap used by major public sector borrowers; closing zombie enterprises in such areas as steel, coal, shipbuilding among others; and introducing legislation to regulate the expanding shadow banking sector.

• China needs to look back at the reforms of Premier Zhu Rongji in the mid-1990s when he cleaned up the banking system by increasing capital, forming asset management companies to take off bad debts from the banks and started closing zombie companies.

• All of this, will cause a decline in China’s GDP, to levels that could drop GDP to below 6%.

• How President Xi deals with these financial challenges will determine the future level of China’s GDP growth, which in turn will greatly influence China’s trade with the rest of the world. This is one of the largest uncertainties facing 2018 and beyond.”

The economic situation of China which prompted my recommendations 18 months ago has now only become more difficult since the start of the trade dispute between the US and China.

I now look forward to spending the next 20 minutes to questions from the audience.