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Economics of Money and Banking
Final Paper

Most experts today tend to consider that a new banking crisis is about to burst. What would be the origins of such a crisis? Would financial institutions, governments and regulators be better prepared than in 2007?

Introduction

It is just a matter of time before a new crisis would hit the global financial system: this is the recurrent sentiment among almost every expert in the field. One of the main signals is that the combined debt of all countries has surged in the last decade since the Great Recession (2007-2008), surpassing the incredible threshold of 300% of GDP at the beginning of 2019 and reaching almost $250 trillion[1]; this figures are even more impressive when compared with the 2007 levels, when the global debt/GDP ratio was around 270% accounting for $142 trillion[2].

However, in this paper I would like to focus the analysis on one specific country, China, because I do believe that it will be the starting point of the next global crisis. To support this statement I will take into account different problematic aspects of Chinese economy that could ignite a spillover effect all around the world: the first one is surely the enormous size of the so-called "shadow banking" and its relevance in the Chinese financial landscape; in second place, I will deal with China's overall debt (both public and private), tied up with its GDP growth slowdown; my last point will be reserved to analyse the implications of a "credit bubble" that could burst (or is already bursting) in the Chinese system.

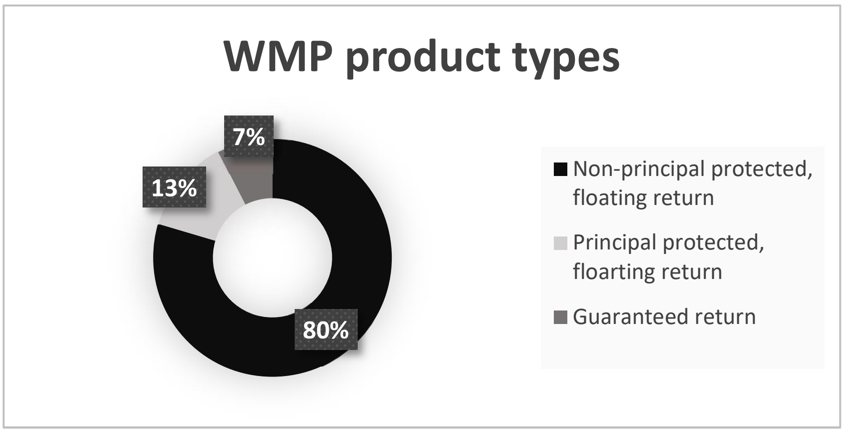
[1] C. Oguh & A. Tanzi (2019). *Global Debt of $244 Trillion Nears Record Despite Faster Growth*. Bloomberg [online]. Available at https://www.bloomberg.com/news/articles/2019-01-15/global-debt-of-244-trillion-nears-record-despite-faster-growth

[2] A. Sedghi (2015). *Global debt has grown by $57 trillion in seven years following the financial crisis*. The Guardian [online]. Available at https://www.theguardian.com/news/datablog/2015/feb/05/global-debt-has-grown-by-57-trillion-in-seven-years-following-the-financial-crisis

Shadow banking: a bomb already triggered?

Shadow banking can be defined as the entirety of markets, institutions and intermediaries which supply banking services without being subject to the relative regulations. This sector has consistently increased its weight during the last years: according to the 2017 Financial Stability Board (FSB) *Global Shadow Banking Monitoring Report*[3] it reached a staggering $45.2 trillions for the 29 jurisdictions considered, representing over 80% of global GDP; China contributed massively with $7 trillion, i.e. 15.5% of the total amount; in that same year, shadow banking accounted for 15.7% of Chinese corporate financing. Why then China is relying more and more on this kind of financing tool, which is harder to keep under control and to regulate?

In order to counterbalance the negative effects of the Great Recession, China poured into its economy an incredible amount of money, something like $600 billion, which have been injected not only through ordinary channels (e.g. formal bank loans) but also thanks to other institutions such as state banks and investment funds. More specifically, there has been a tendency in the last years to rely more and more on a specific kind of "shadow" product, the so-called wealth management products (WMPs), which by mid-2017 had a market of $4 trillion[4]; they typically offer convenient interest rates, promising or sometimes guaranteeing good returns for the customer. It is important to notice, however, that there are three models of WMPs: those which ensure a return, those whose principal is protected but with floating returns and finally those whose principal is not protected and returns are not secure. As shown in the graph below[5], the last category outreach by a large margin the other two: this means that four WMP products out of five are highly risky; and since almost 45% of WMPs are sold to individuals[6], the exposure for Chinese households is massive. In this sense, personal debt in China is on the rise and, while Chinese policymakers could be satisfied by lowering debt pressures on state companies, this means that in the case of a crisis (for example in the real estate market, a prediction not so hard to imagine[7]) there would be great consequences for the entire economy.



[3] http://www.fsb.org/2018/03/fsb-publishes-global-shadow-banking-monitoring-report-2017/

[4] A. Collier (2017). *Rising middle class would face harsh lesson if WMPs market collapses*. Financial Times [online]. Available at https://www.ft.com/content/a6086a9a-5059-11e7-bfb8-997009366969

[5] Data source: Bank of International Settlements; BIS Working Papers n°701, *Mapping shadow banking in China: structure and dynamics*

[6] *Ibidem*

[7] C. Balding (2018). *Why China Can't Fix Its Housing Bubble*. Bloomberg [online]. Available at https://www.bloomberg.com/opinion/articles/2018-06-24/why-china-can-t-fix-its-housing-bubble

As reported by the European Central Bank, "the increased involvement of shadow banking entities in credit intermediation and capital markets […] increase the potential ramifications of adverse developments in the shadow banking sector on the financial system and real economy"; given the size of China's economy and its impact in today's world, I believe that the seeds of the future global crisis lie in its shadow banking sector.

The burden of the debt

Unfortunately, shadow banking is not the only sword of Damocles hanging upon China's head.

We are more than 10 years away from the Great Recession; at that time, the global financial system was on the verge of a general collapse due to the outstanding level of growth of household and institution debt; thanks to the central banks' common efforts and accommodating orientation, a second recession has been avoided and the foundations for the actual recovery has been laid. Nonetheless, they have been also one of the factors that led to the huge expansion of public and private sector budgets and the increase in debt levels: it would be time to take advantage of current favourable conditions to implement a combination of more balanced policies aimed at supporting sustainable expansion.

Chinese debt, however, is not shrinking by any means: according to the International Monetary Fund (IMF), 43% of new global debt since 2007 has been caused by China[8]; the Bank of International Settlements observes that China's overall debt is equal to 255.7% of its GDP[9] (with the corporate debt reaching 160.3%) and that its credit to the non-financial sector/GDP ratio is 208.8%, well above the situation in the US or in Europe[10]. In addition, the Institute for International Finance says that in the 2008-2018 decade Chinese debt/GDP ratio soared from 177% to 299%. All these indicators are not promising, although Chinese savings rates are among the highest in the world: that is because these same rates were already consistent before the outburst of the crisis in 2007-2008, when the debt was much lower. All these tensions, moreover, could be exacerbated by other factors such as the trade tensions between China and the US and the slowdown of the Chinese economy (the current 6.4% GDP growth is the lowest figure since 1990).

The reasons why I include the high level of debt as one of the possible causes of the next crisis can also be found if we draw a comparison with the Greek disaster[11]. In those days, severe cuts to the national debt had an incredible repercussion on the real economy, mainly because the state-controlled banks and funds were at the same time creditors of the government itself and SOEs; this meant that the restrictions imposed shifted losses from one national branch to another one and so on, resulting in new loans needed to cover the losses. This vicious circle could be way bigger in China, clearly because of the incomparable sizes of

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[8] C. Bray (2018). *Could China find itself at the centre of the next financial crisis because of its mounting debt?*. South China Morning Post [online]. Available at https://www.scmp.com/business/article/2163897/could-china-find-itself-centre-next-financial-crisis-because-its-mounting

[9] T. Wibawa (2019). *China's looming great wall of debt may have 'major global implications'*. ABC [online]. Available at https://www.abc.net.au/news/2019-01-20/chinas-looming-great-wall-of-debt/10713614

[10] C. Bray (2018). *Idem*

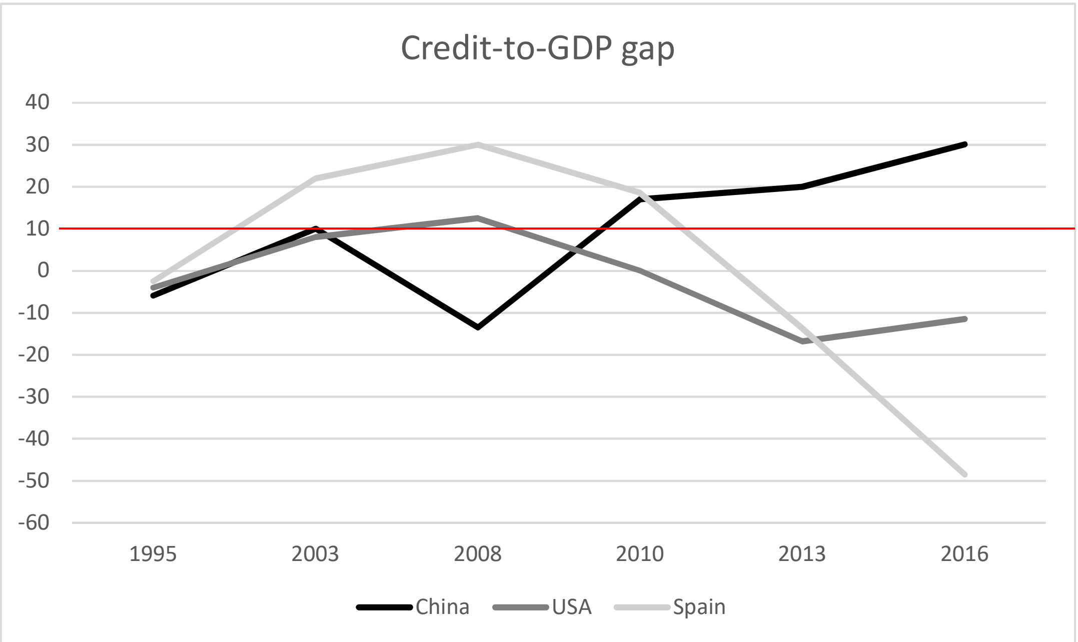
[11] P. Mourdoukoutas (2018). *Debt, Not Trade War, Is China's Biggest Problem*. Forbes [online]. Available at https://www.forbes.com/sites/panosmourdoukoutas/2018/11/24/debt-not-trade-war-is-chinas-biggest-problem/#7fd5409e4c4d

the two economies but maybe more importantly because the Chinese central state owns a huge amount of banks, corporations, firms and pension funds. In case of a financial crisis, the consequences for the global system will not be minimal, as also stated by Haibin Zhu, JP Morgan chief China economist[12]: “Given the size of the economy and of the debt burden, and the extensive cross-border financial connections, a disruptive debt event in China could quickly spread to other parts of the globe. China could well be the epicentre of the next crisis.”

Why it is important to reason about a credit bubble

As already mentioned in the shadow banking paragraph, China heavily intervened in the aftermath of the Great Recession injecting billions and billions of yuan into its economy. This tendency has not stopped in the following years, with Beijing always ready to facilitate credit access for households and companies. The rapid development of the country has been accompanied by an increase in productivity which has fallen a great deal in recent years, as is normal. The credit doors have been opened to maintain growth. The government has been trying to harness it for a while, but for an economic system easy credit is like a drug: if the doctor doesn't want to prescribe it, you look for the drug dealers. A large shadow credit sector has been developing, without too many limitations because nobody wants to see companies or privates fail and until now the rapid growth has forgiven all failures.

The Chinese credit expansion has been lasting for a very long time and its proportions are extremely large, as indicated in the graph below[13]; other historical examples of “credit booms” of such weight and pace are few in number and not reassuring. Chinese policymakers should be concerned and should address the possible deadly combination of high debt and too much credit before surpassing the point of no return. The current season of stable financial markets and



[12] C. Bray (2018). *Idem*

[13] Data source: Bloomberg. P. Panckhurst & A. Leung (2016). Available at https://www.bloomberg.com/graphics/2016-china-banking/

vigorous growth worldwide offers a unique opportunity for dealing with these problems, in particular they should resolve the tripartite issue of decreasing growth, skyrocketing debt and excessive credit: without proper countermeasures, the reverberations across the entire world would be very likely, given the geopolitical stature of the Asian giant. These fears are even more fuelled by the risks that the Belt and Road Initiative (BRI), Xi Jinping's gargantuan development strategy launched back in 2013, could become a factor of high uncertainty in the Chinese banking and financial landscape[14]; in particular, the state could accumulate hundreds and hundreds of billions of dollars in non-performing loans (NPLs) if the projects connected with the BRI will fail. This possibility is not so remote since a great number of programs involves developing countries with a higher risk profile and, significantly, China has "soft budget constraint" (i.e. the concept of avoiding the bankruptcy of SOEs at any cost): the expansion of these restrictions at an unprecedented pace (indeed BRI projects see a great participation of SOEs) are going to "generate unprecedented consequences for the global financial system", as pointed out by Xu Chenggang[15], professor at Beijing's Cheung Kong Graduate School of Business.

Conclusion

China has emerged in the last two decades as one of the pillars upon which the future international relations will be built. This is true also for what concern the economic sphere: it is actually the second biggest economy in the world behind the US and according to numerous sources it will surpass them in the following years; therefore a crisis in the Middle Kingdom will have powerful backlashes in this more and more interconnected and globalized world. Most of all, as explained by the vice-president of the Mercator Institute for China studies Bjorn Conrad[16], "a risk to China's banking system is, by default, a risk to the global banking system"; the factors for this to happen are all there, as explained in the previous paragraphs. Moreover, it seems that Chinese policymakers are ignoring what the Great Recession taught the world about how big crises erupt and are later intensify: flawed regulations and accommodating regulators pave the way for financial apathy, which leads to lower investments and compromised households credit; the crisis will then be "exported" due to the inevitable linkages between countries all over the world.

One final assumption (not directly related with China) on the possible timeline of the next crisis: following the analysis of Simon Ward[17], it could burst in 2027, when three crucial economic cycles (regarding stockpiles, investments and housing, named after the economists Kitchin, Juglar and Kuznets) will witness a synchronized slowdown due to their different duration (3-5, 7-11 and 15-25 years respectively).

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[14] K. Gilchrist (2017). *China's 'Belt and Road' initiative could be the next risk to the global financial system*. CNBC [online]. Available at https://www.cnbc.com/2017/08/24/chinas-belt-and-road-initiative-could-be-the-next-risk-to-the-global-financial-system.html

[15] *Ibidem*

[16] *Ibidem*

[17] M. Cellino (2019). La prossima grande crisi sarà nel 2027. Lo dicono i 3 cicli dell'economia. Il Sole 24 Ore [online]. Available at https://www.ilsole24ore.com/art/finanza-e-mercati/2019-04-03/la-prossima-grande-crisi-sara-2027-dicono-3-cicli-dell-economia-184612.shtml?uuid=AB46ngkB

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