



China's Credit Crunch: Deleveraging and Risks to Financial Resilience

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Explaining China's economic resilience

How has China continued growing without crisis despite a record-breaking credit expansion?

- Financial system growth itself critical- \$29 trillion in bank asset growth since 2008, vs. \$7 trillion in GDP growth
- Maintaining the same pace of economic activity required an increasingly unstable financial system, in both assets and liabilities
- The deleveraging campaign initiated in late 2016 marks a sea change in credit growth, risks now rising
- A new political bargain: Changes in Beijing's credibility pose greatest risk to financial stability

Deleveraging is real. Credit and bank asset growth are slowing.

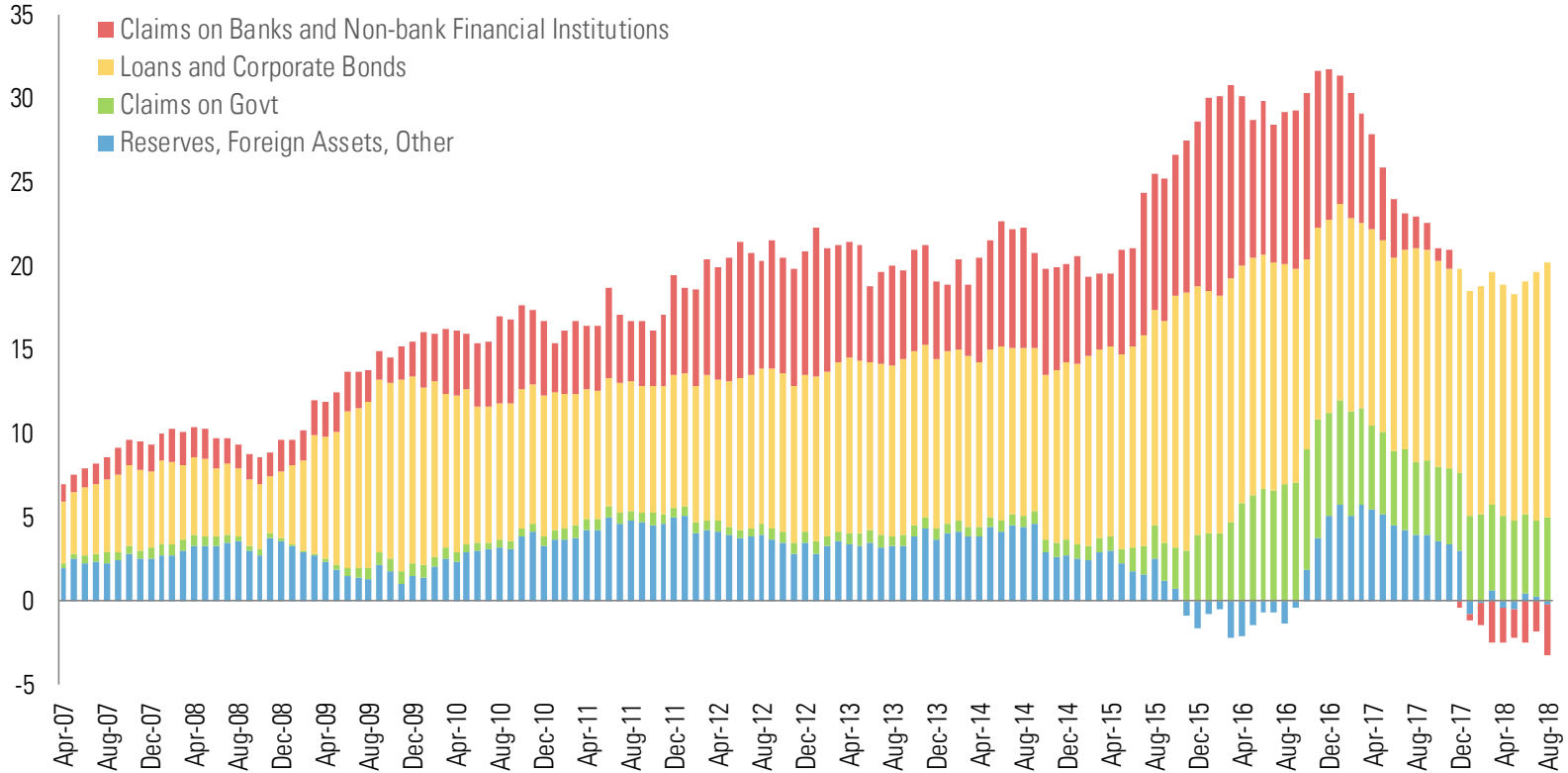
Percent YoY



Source: People's Bank of China.

Shadow banking channels are contracting

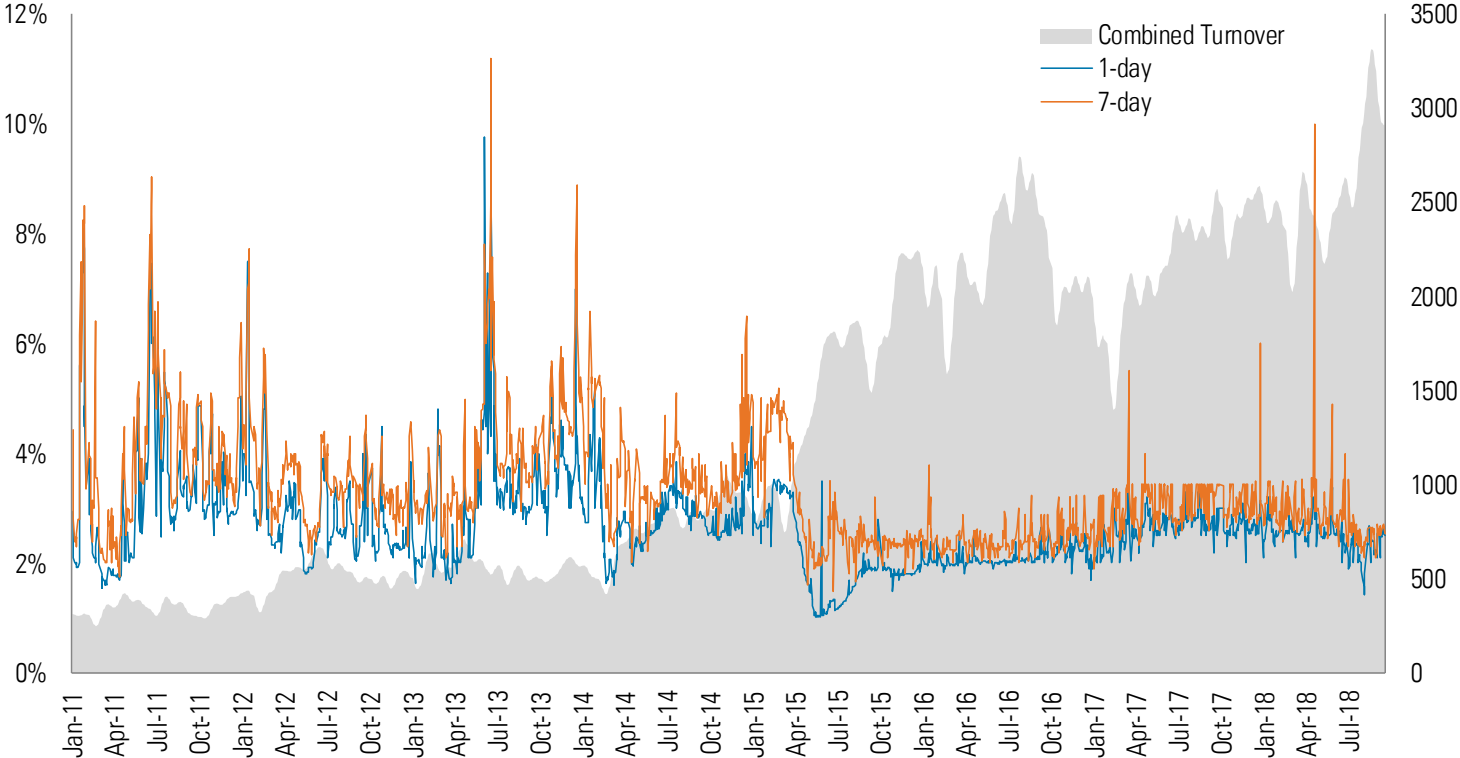
Bank asset growth in trillion yuan, 12m rolling sum



Source: People's Bank of China.

The growth of shadow banking and China's money markets

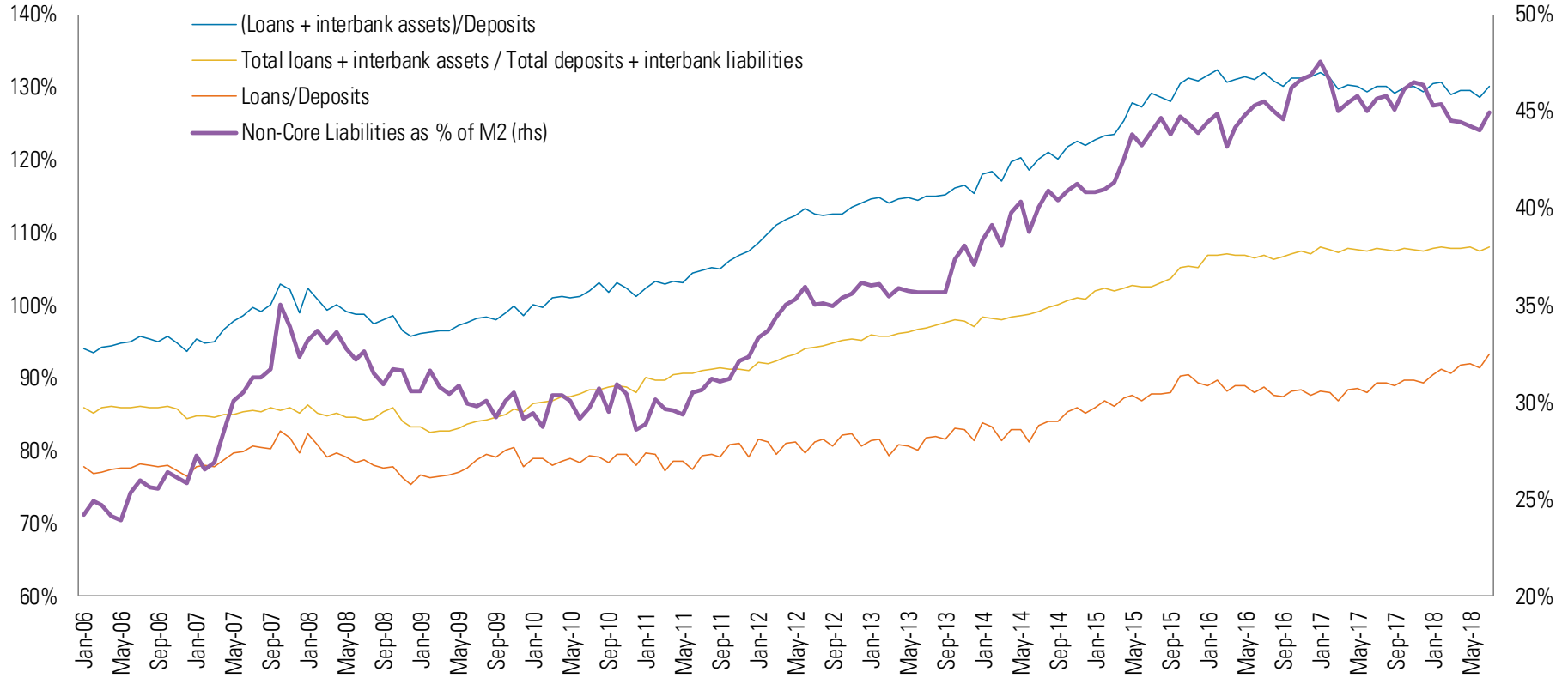
Percent, Billion Yuan (RHS)



Source: People's Bank of China, Bloomberg.

Interbank and non-core liabilities/WMPs no longer expanding

Percent

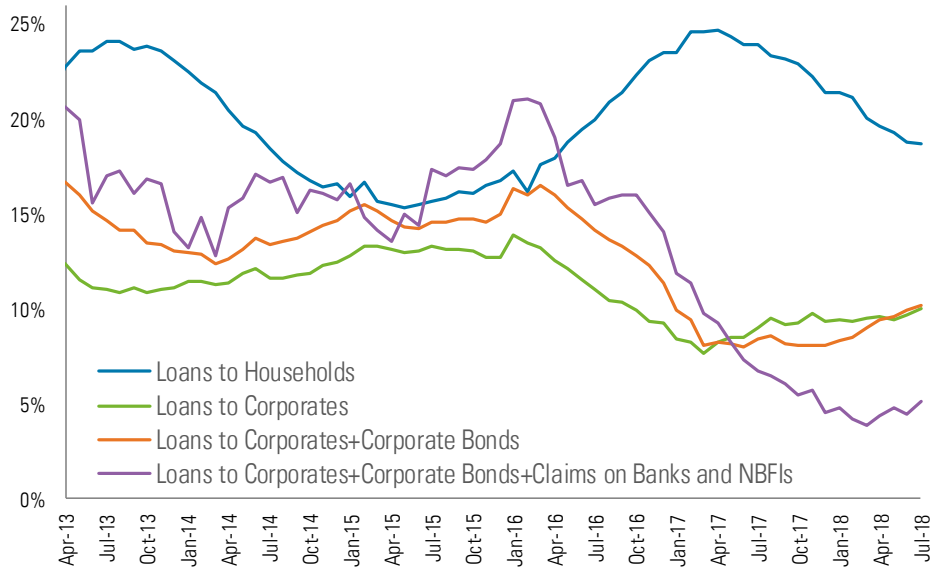


Source: People's Bank of China.

Distribution of credit shifting, corporates are squeezed

Credit Growth to Households, Corporates, 2013-2018

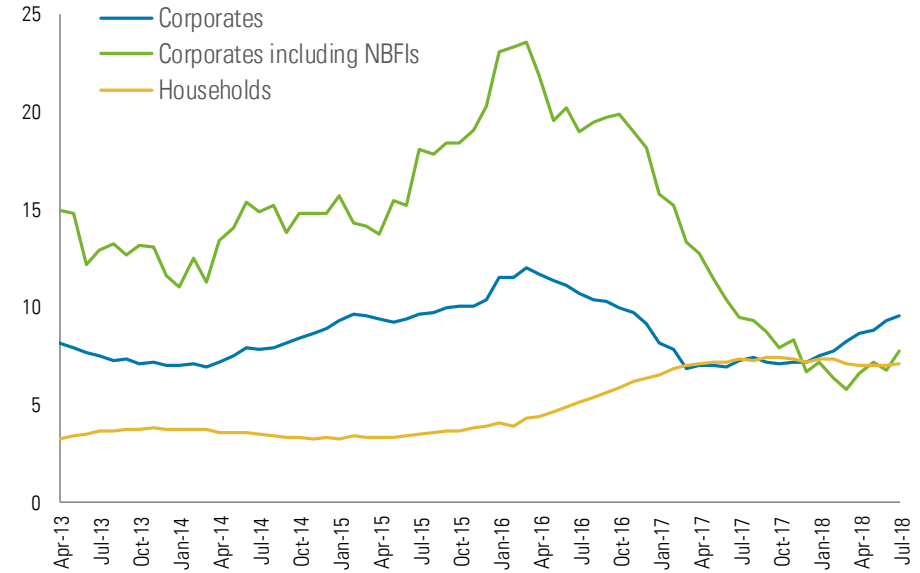
YOY percent



Source: People's Bank of China.

Loans to Households and Corporates, 2013-2018

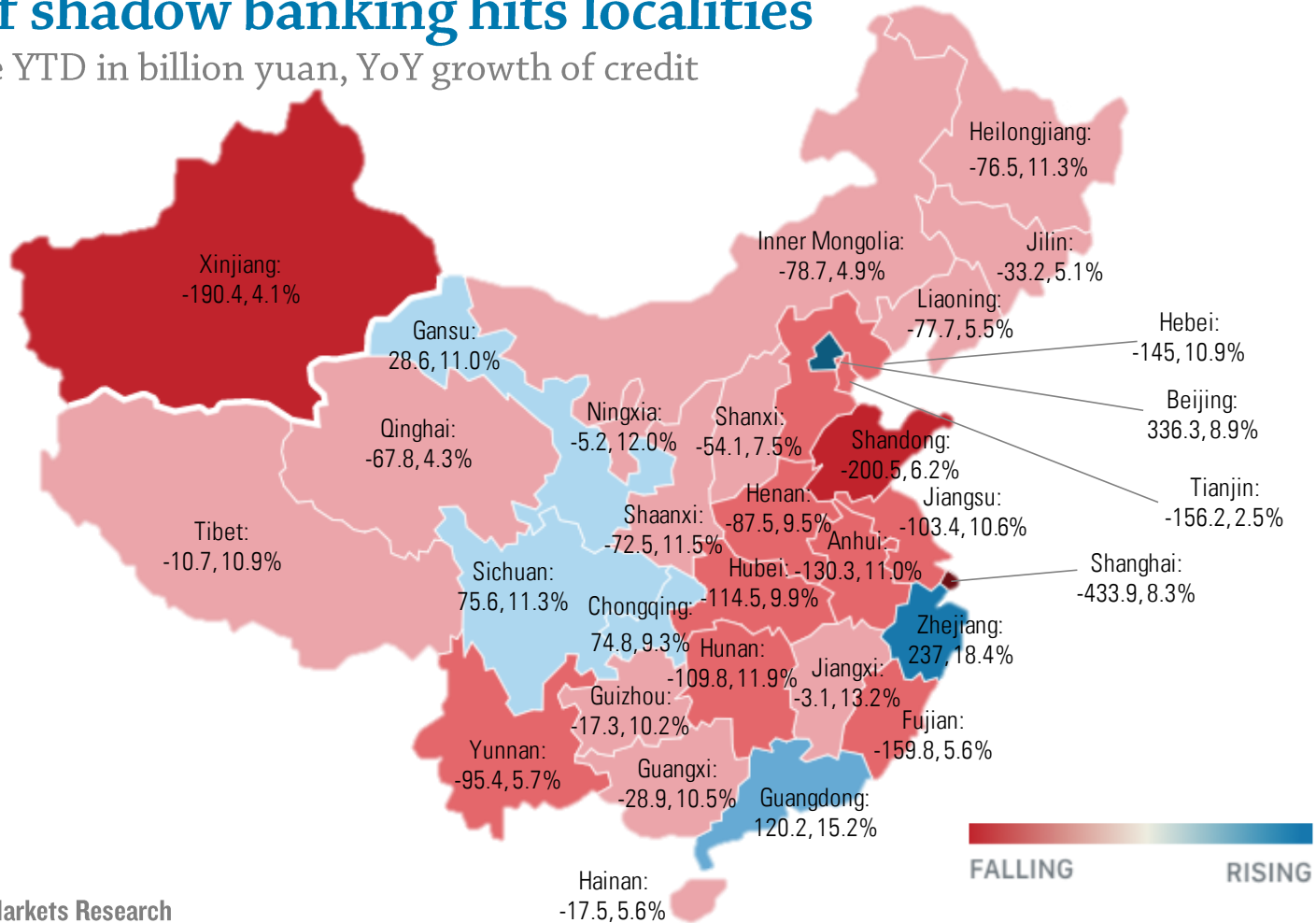
12m rolling sums, trillion yuan



Source: People's Bank of China.

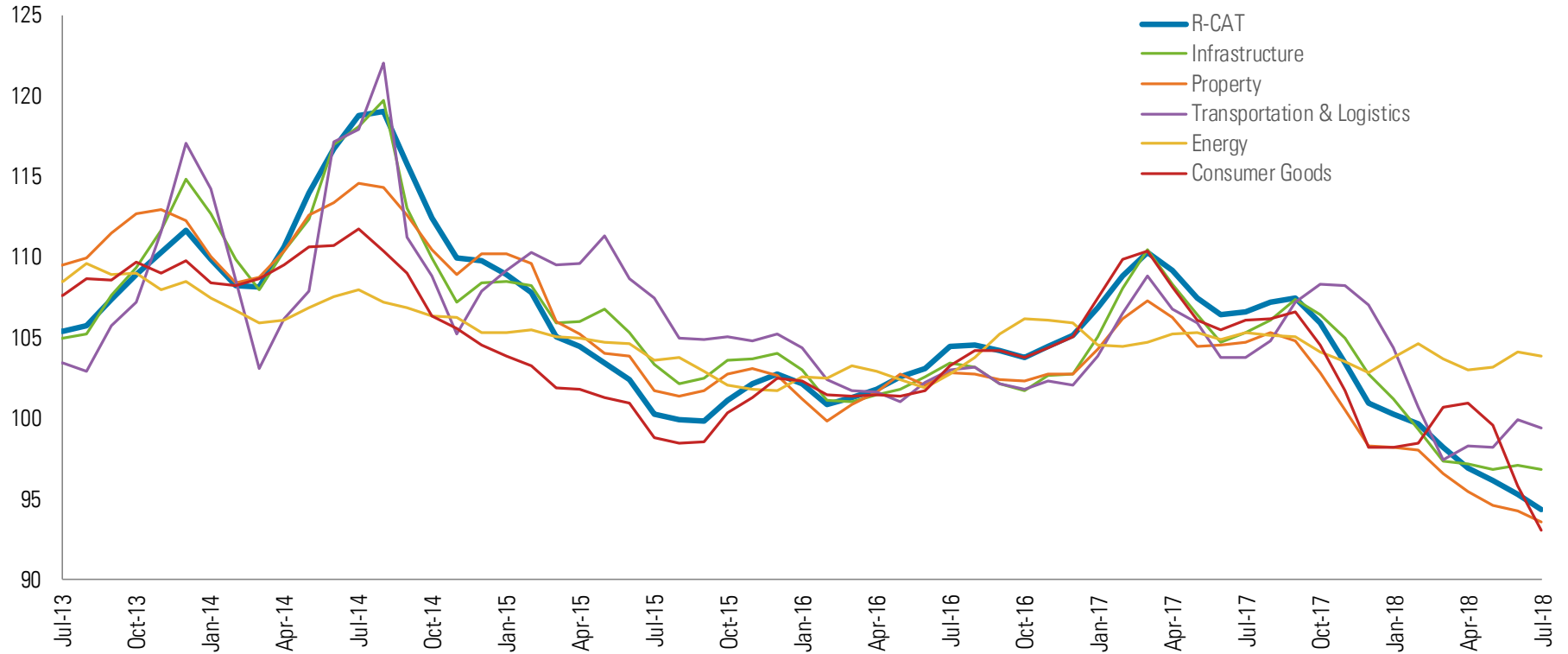
Decline of shadow banking hits localities

Credit impulse YTD in billion yuan, YoY growth of credit



China Activity Tracker (R-CAT) shows declining output growth

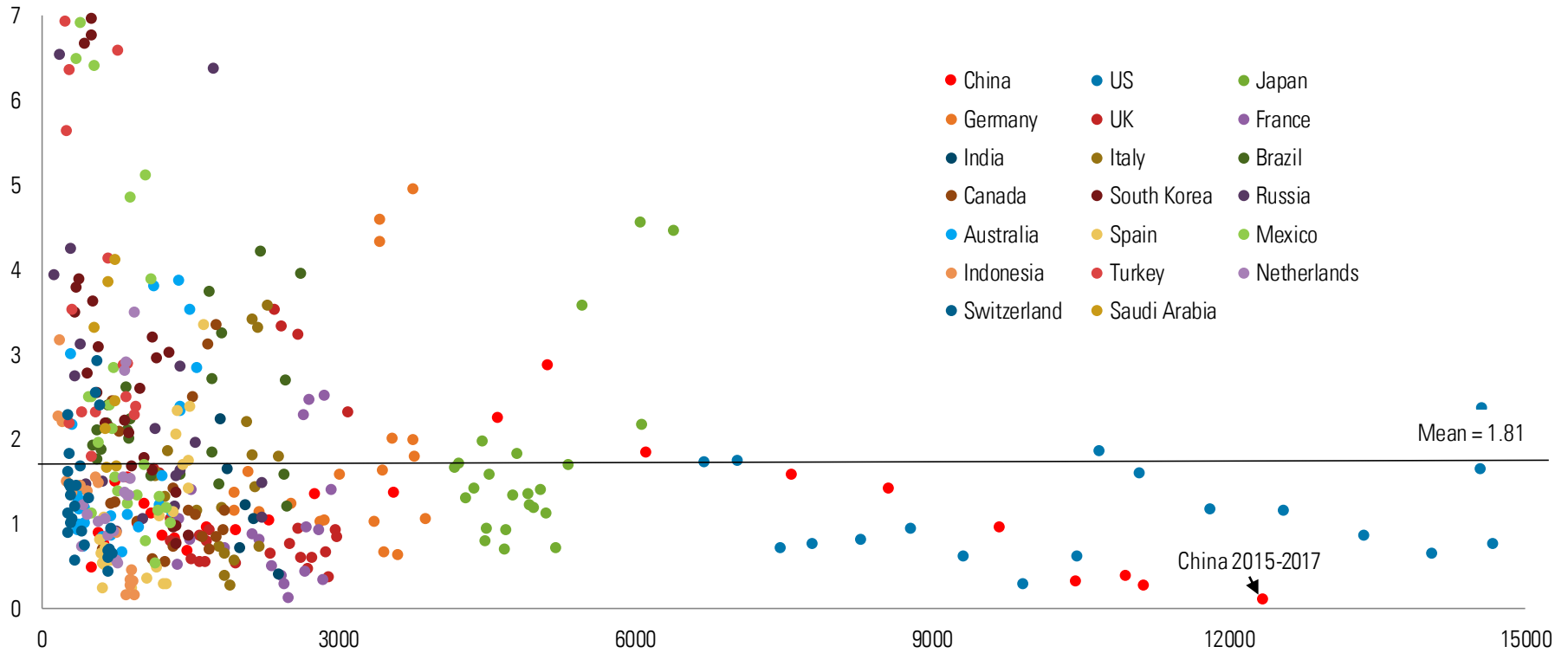
3mma, Previous year = 100



Source: Rhodium Group.

Lack of Volatility in GDP/Industrial Value-Added

Standard deviation of 3-year intervals of YoY GDP Growth, Versus GDP



Source: National Bureau of Statistics, Bloomberg.

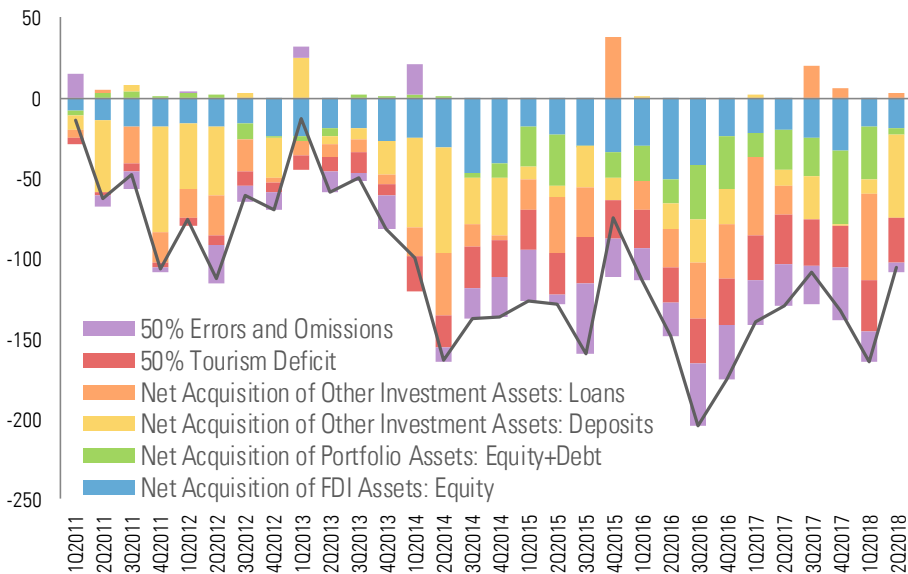
Policy Outlook

- Monetary easing will continue if shadow finance remains under control, which is probable
- More RRR cuts and use of the PBOC balance sheet probable
- Trade conflict and external pressure reinforce easing impulse
- Corporate credit risk rising, credit spreads widening, defaults emerging
- Raising rates not an option to defend the currency- external adjustment more likely than internal

Currency: Outflows are inevitable, inflows are contingent

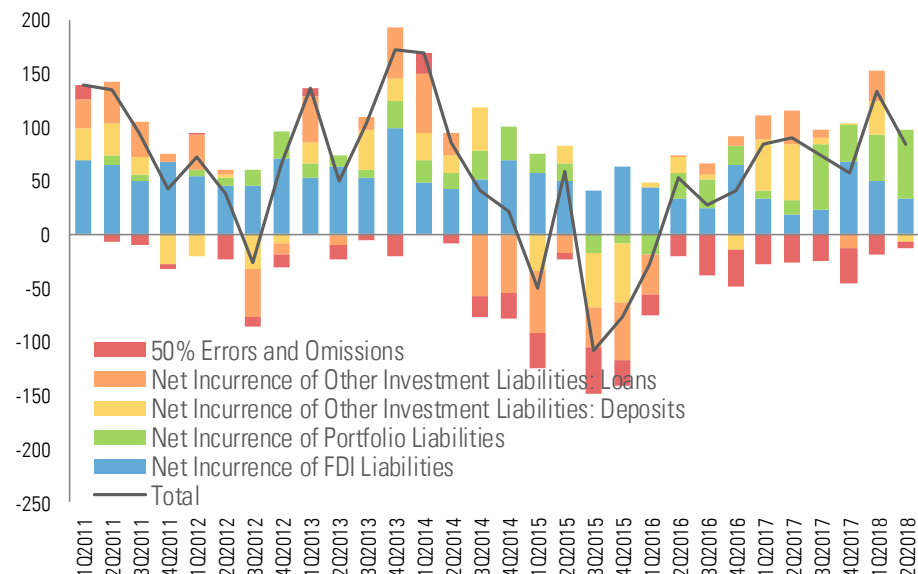
Estimated Capital and Financial Account Activities of Chinese Residents, 2011-2018

Billion USD



Estimated Capital and Financial Account Activities of Non-Residents, 2011-2018

Billion USD



Source: Chinese State Administration of Foreign Exchange.

Closing thoughts

- Stress in China's local government financing conditions underappreciated
- Deleveraging campaign has driven a significant adjustment in credit conditions over past year
- Exchange rate management untenable in current form, more yuan depreciation likely
- Monetary easing likely to continue, with potential stabilization of economy in late 2018/early 2019
- Returning to previous rates of growth highly improbable