
Next Financial Crisis: Made in China?

Guest Lecture for Queen's International MBA Programme



23rd October 2015

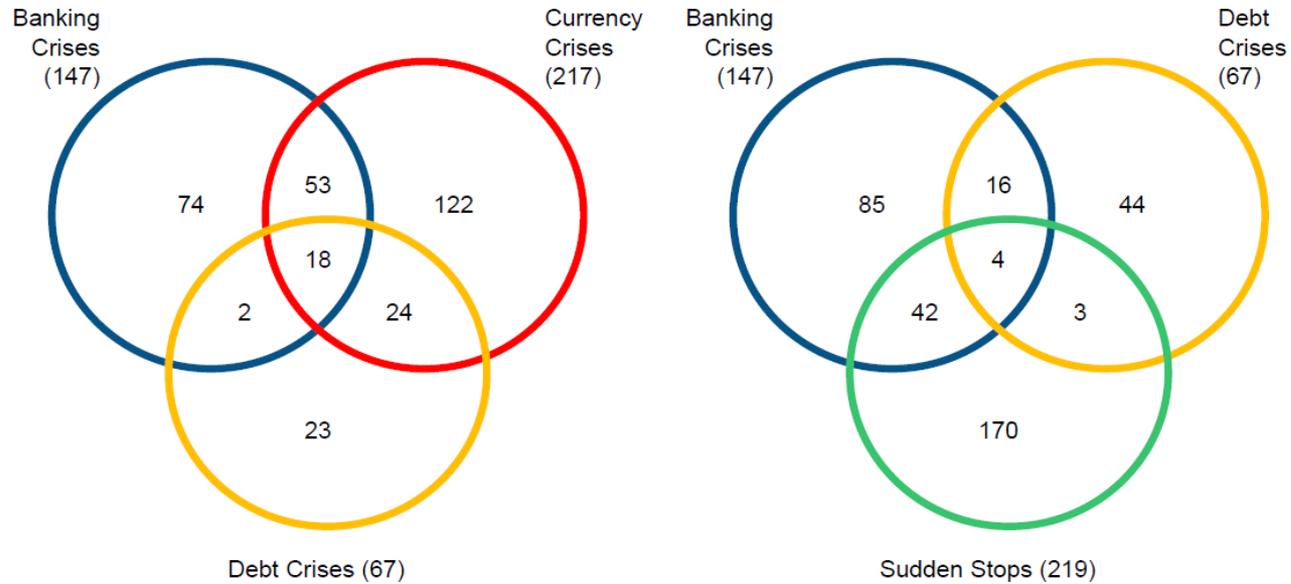


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Financial crises are more common than you think

Number and type of financial crises since 1970



Source: Financial crises: Explanations, Types and Implications, IMF Working Paper WP/13/28

Credit Crunch & Financial / Banking crises

- **What is a credit crunch?**

a sudden reduction in the general availability of loans or credit or a sudden increase in the cost of credit

- **What is a banking / financial crisis?**

a sharp decline in the value of banks' assets resulting in the apparent or real insolvency of a bank

Financial crisis – is a sharp, brief ultra-cyclical deterioration of all or most of a group of financial indicators; asset prices (equities, property), commercial insolvencies and failure of financial institutions

Common features of a financial crisis

1. Credit growth
2. Debt overhang & gearing – hedge debt to speculative debt
3. Shift in policy regime e.g. deregulation
4. Prior monetary tightening – i.e. interest rate rises
5. Accumulation of risky debt – e.g. sub-prime mortgages
6. Speculation & euphoria by borrowers & lenders
7. Increased competition – arrival of new lenders
8. Herd behaviour
9. Reduced risk premia – under-pricing of risk
10. Uncertainty – e.g. freezing up of credit markets

Origins of the last financial crisis

Last decade ('NICE' decade) – low real interest rates



High rates of savings in Asia & increasing profits from oil states



'Glut' of savings on capital markets leading to cheap credit



But low interest rates led to a "search for yield"



Financial innovation / complex products with higher yield



Surplus cash found a home...and the rest is history



A crisis on all levels.....edited highlights

US housing market downturn triggers financial crisis

First run on a UK bank since 1866

Money markets / credit markets froze

Rescue of Bear Stearns

Failure of Lehman Brothers

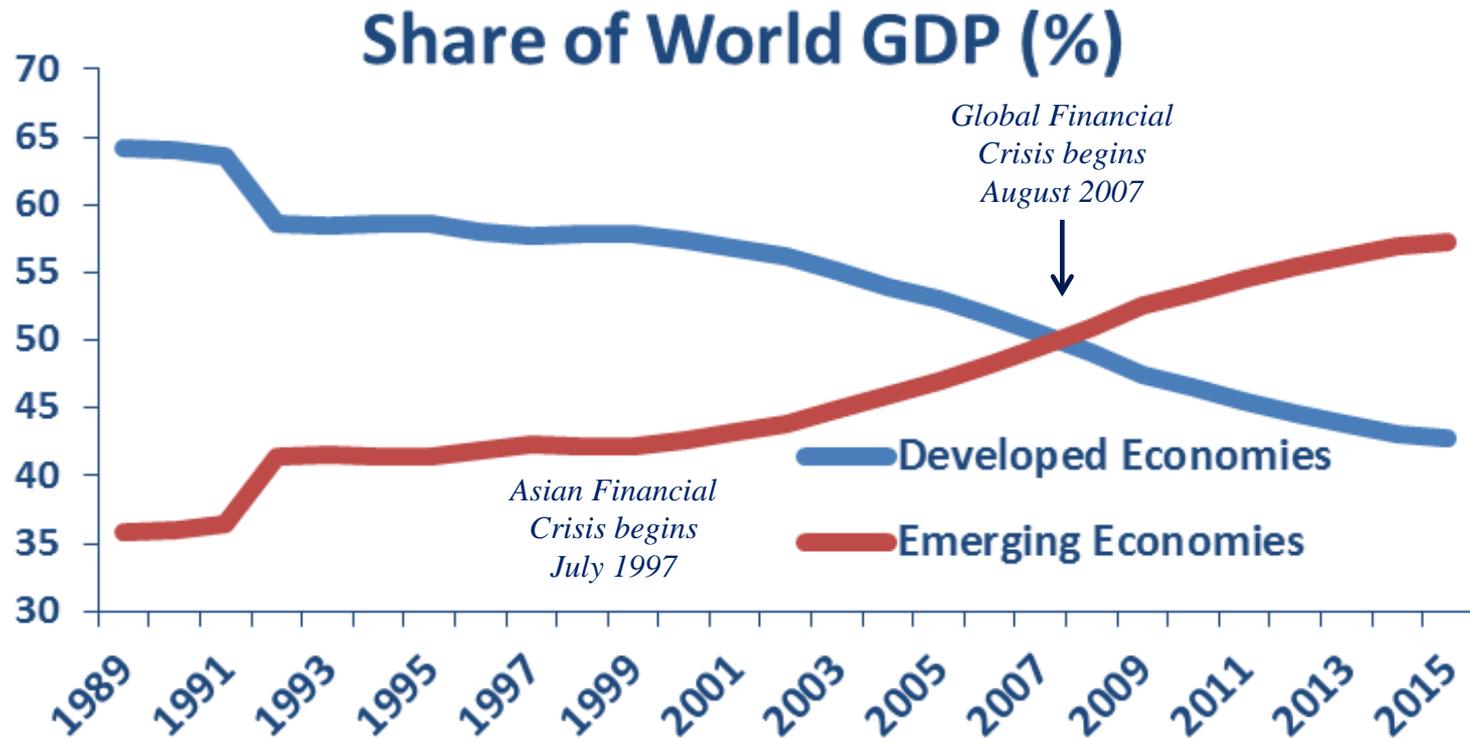
Bail-out of AIG

Investment banks merged with retail banks e.g. Merrill Lynch & Bank of America

Stock market & currency volatility

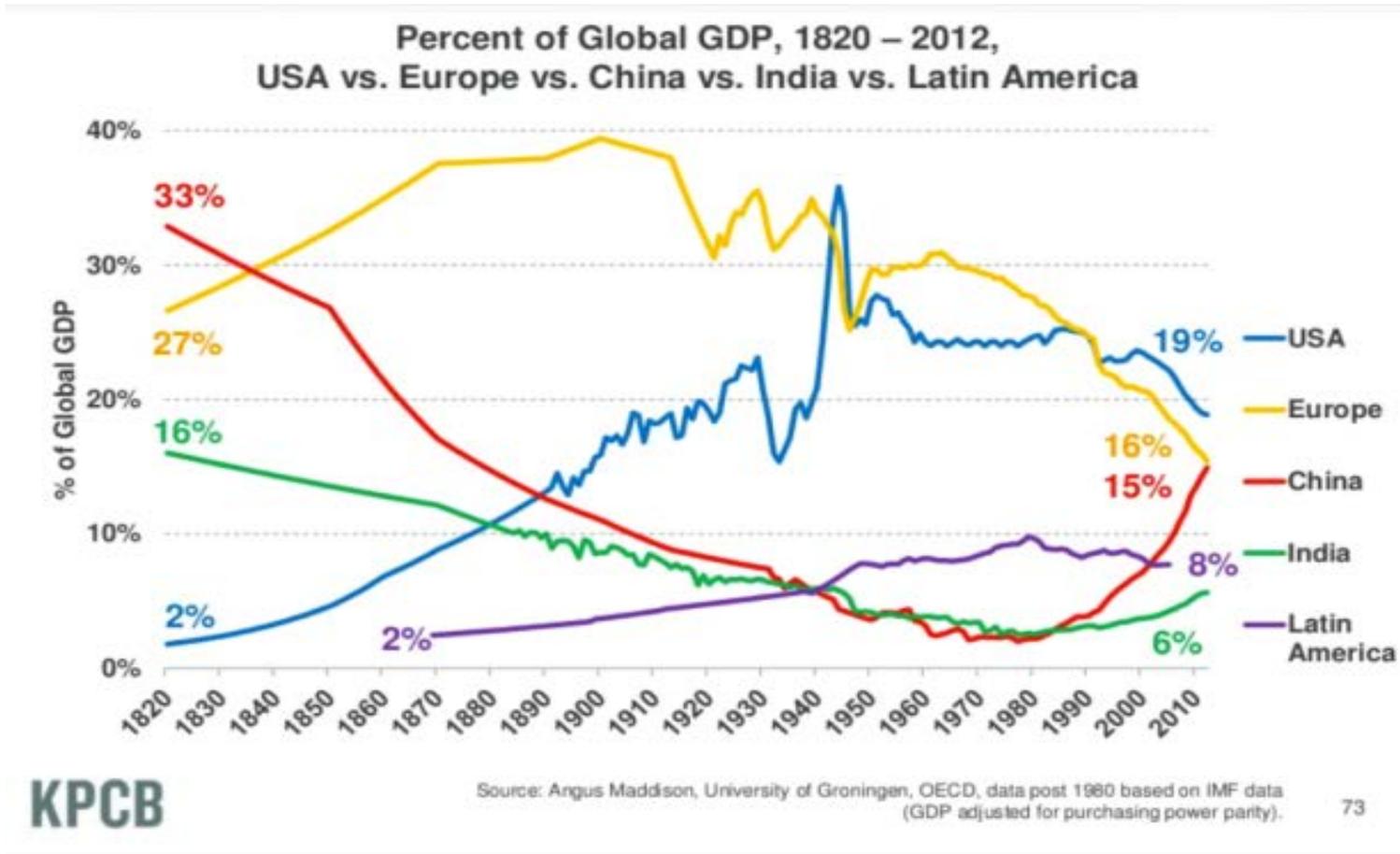
Mexican wave of banking- bail outs including nationalisations / equity stakes

When the GFC began Developed Economies accounted for a larger share of world GDP than Emerging Economies



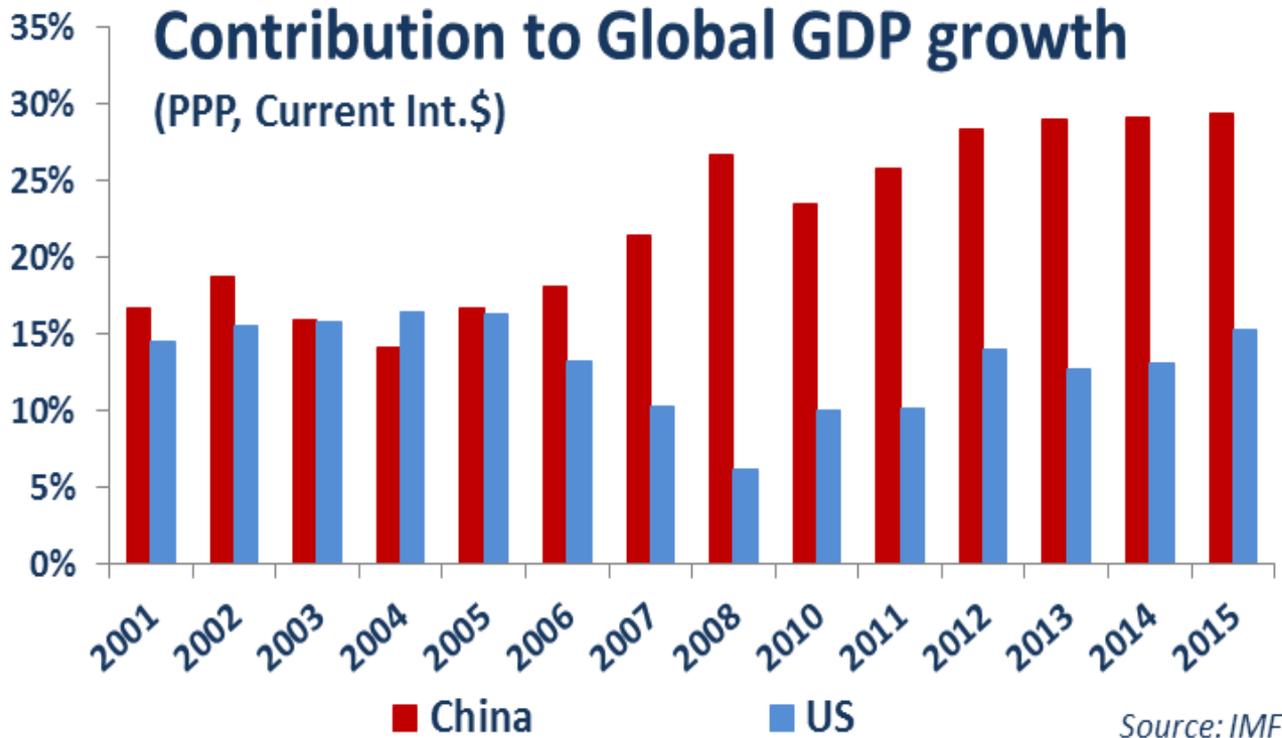
Source: IMF

China's influence on the world economy has changed markedly since the last crisis



KPCB

10 years ago China & the US both contributed equivalent amounts to global growth. Not now!

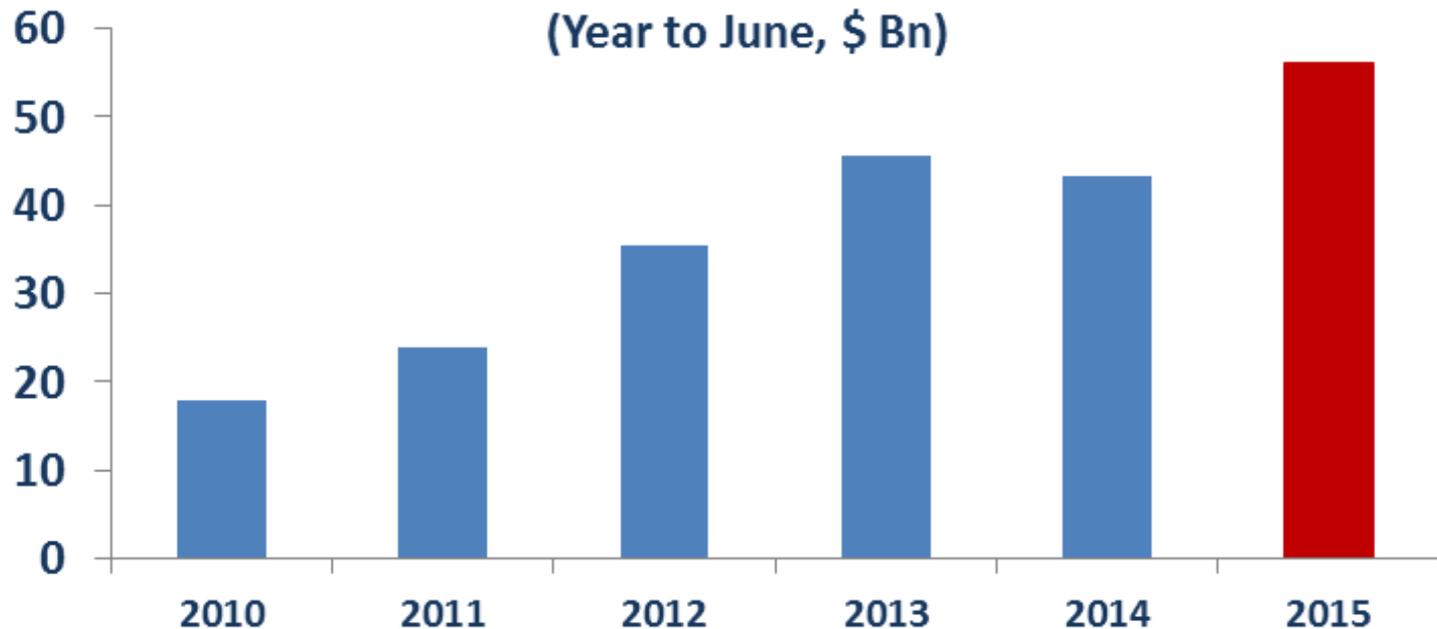


2009 removed as US GDP fell

China has become a more important source of FDI too

China Overseas Direct Investment

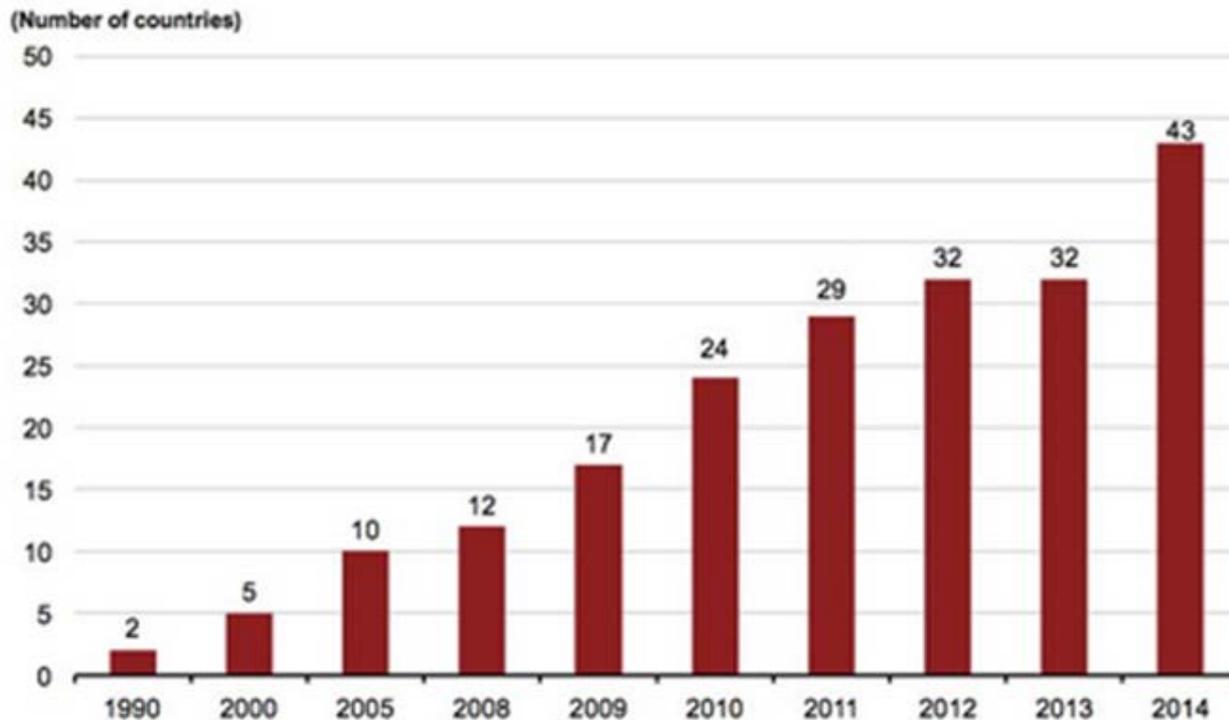
(Year to June, \$ Bn)



Source: Bloomberg

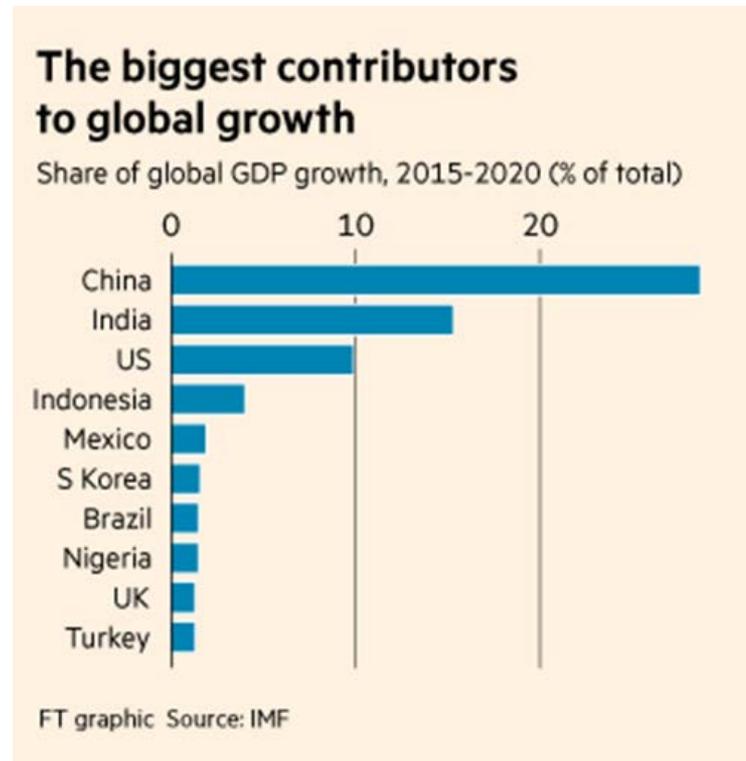
3½ times as many countries now have China as their top export partner as was the case when Lehman's collapsed

Countries with China as Top Export Partner



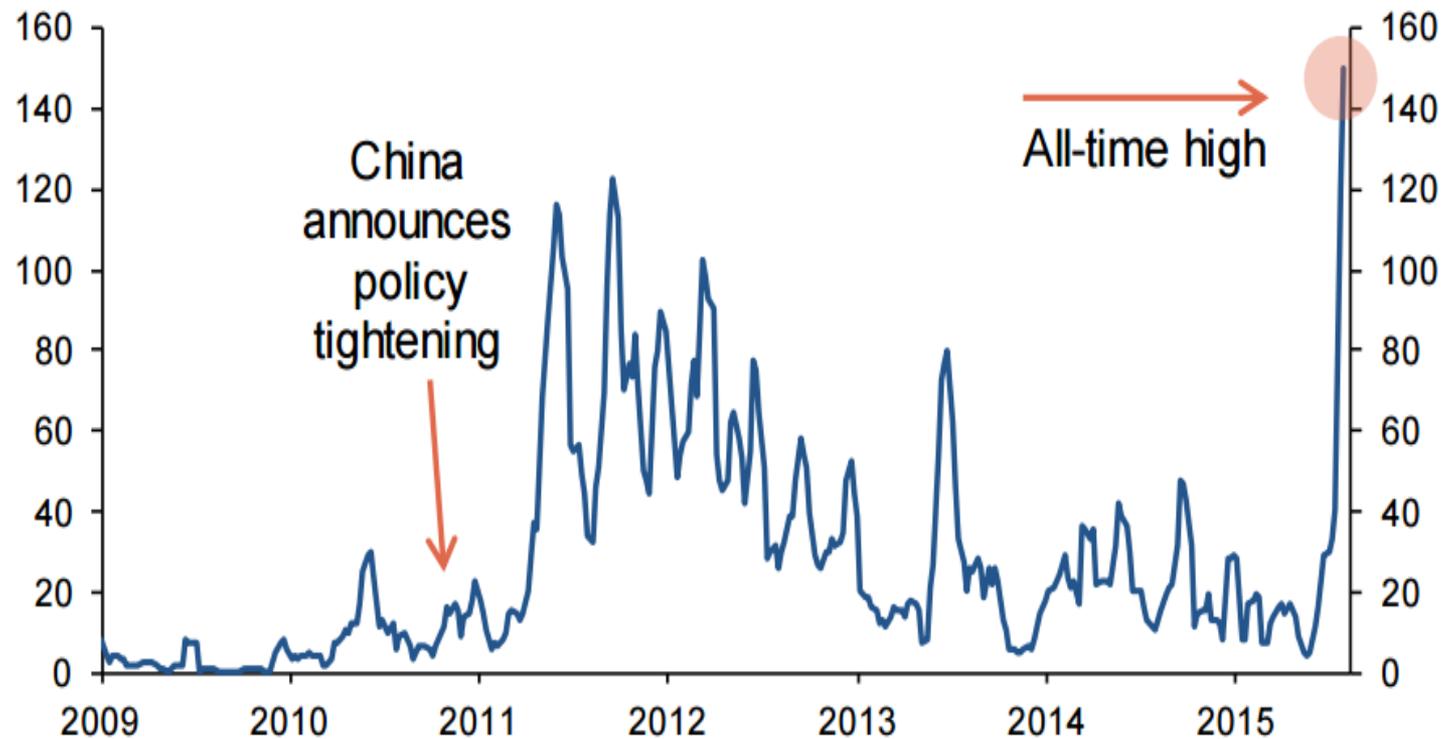
Source: www.investing.com

China & India are set to increase their dominance



The media has been 'talking up' a Chinese crisis?

Fears about China hard landing risk have reached a peak



4 weeks average of news articles related to China hard landing. Latest data 07/09/15 (rebased).

Source: Dow Jones, SG Cross Asset Research/Global Asset Allocation

Central bankers are getting more concerned about global risks & China



Governor Carney acknowledged that the risks to the health of the global economy have intensified over the past month as China's economy has faltered. But he said the U.K.'s domestic economy remains robust, and that central-bank officials are still moving closer to the point when they will begin gently nudging up borrowing costs after almost a decade of near-zero interest rates. "The prospect of a sustained momentum in the UK economy and the gradual firming of underlying inflationary pressure will likely put the decision as to when to start the process of gradual monetary policy normalisation into sharper relief around the turn of the year".

Treasury Select Committee Hearing 16th September 2015



Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term.

FOMC Statement 17th September 2015 (2nd paragraph)



The China Checklist

What's happening?



Economic growth slowing



Disinflation



Sluggish rates of world trade growth



Global interest rates staying lower for longer



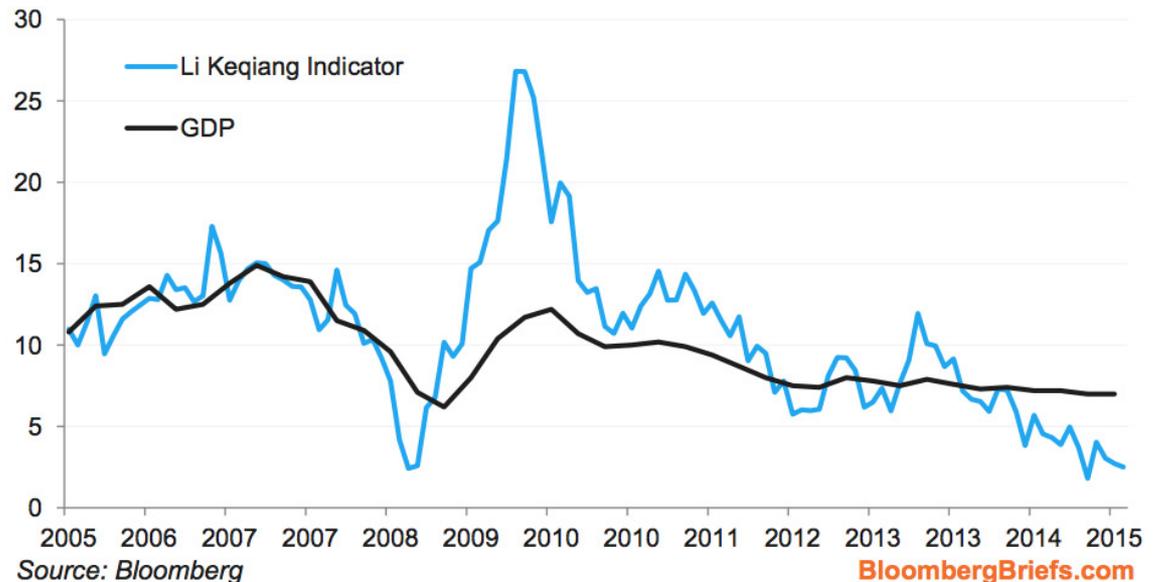
All-out credit crunch / financial crisis



The Chinese economy has slowed from 10% to below 7% but is the true growth rate even lower?



Sinking Li Keqiang Index Contrasts With Stable GDP

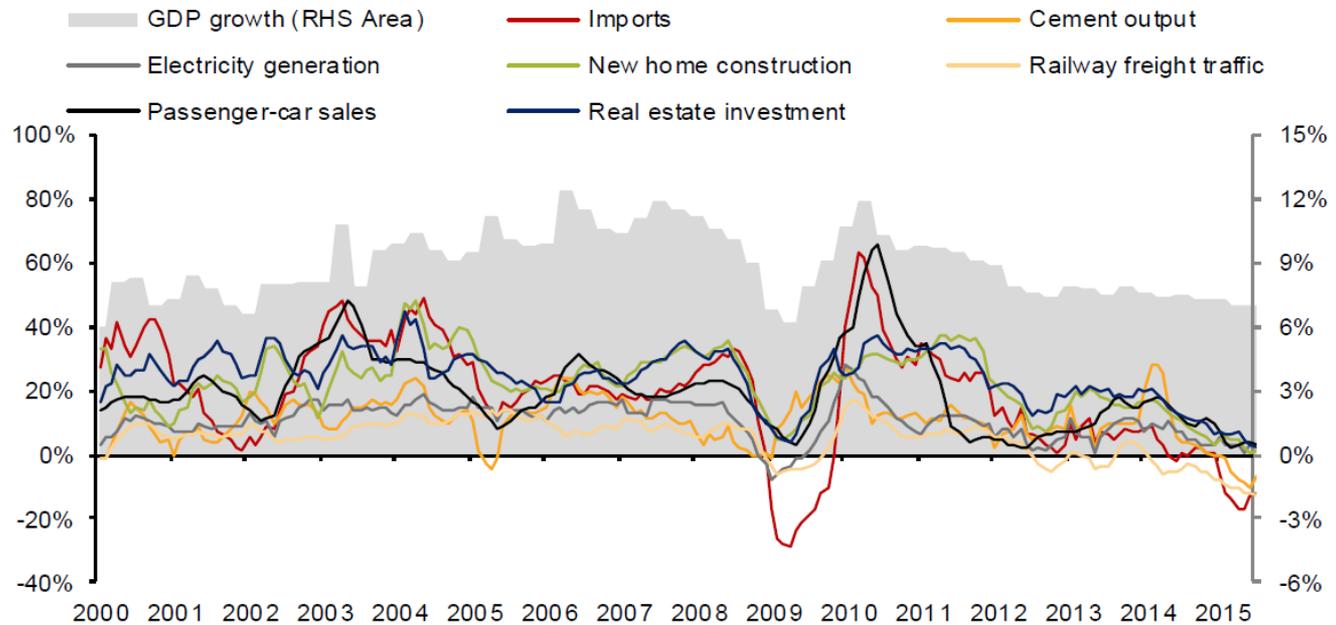


Chinese economic statistics are ‘man made’ and, apart from numbers for electricity use, bank lending and rail freight, are ‘for reference only’ *Li Keqiang Prime Minister speaking in 2013*

Imports, freight traffic & cement output are all falling

China: Key economic indicators suggest a sharper slowdown

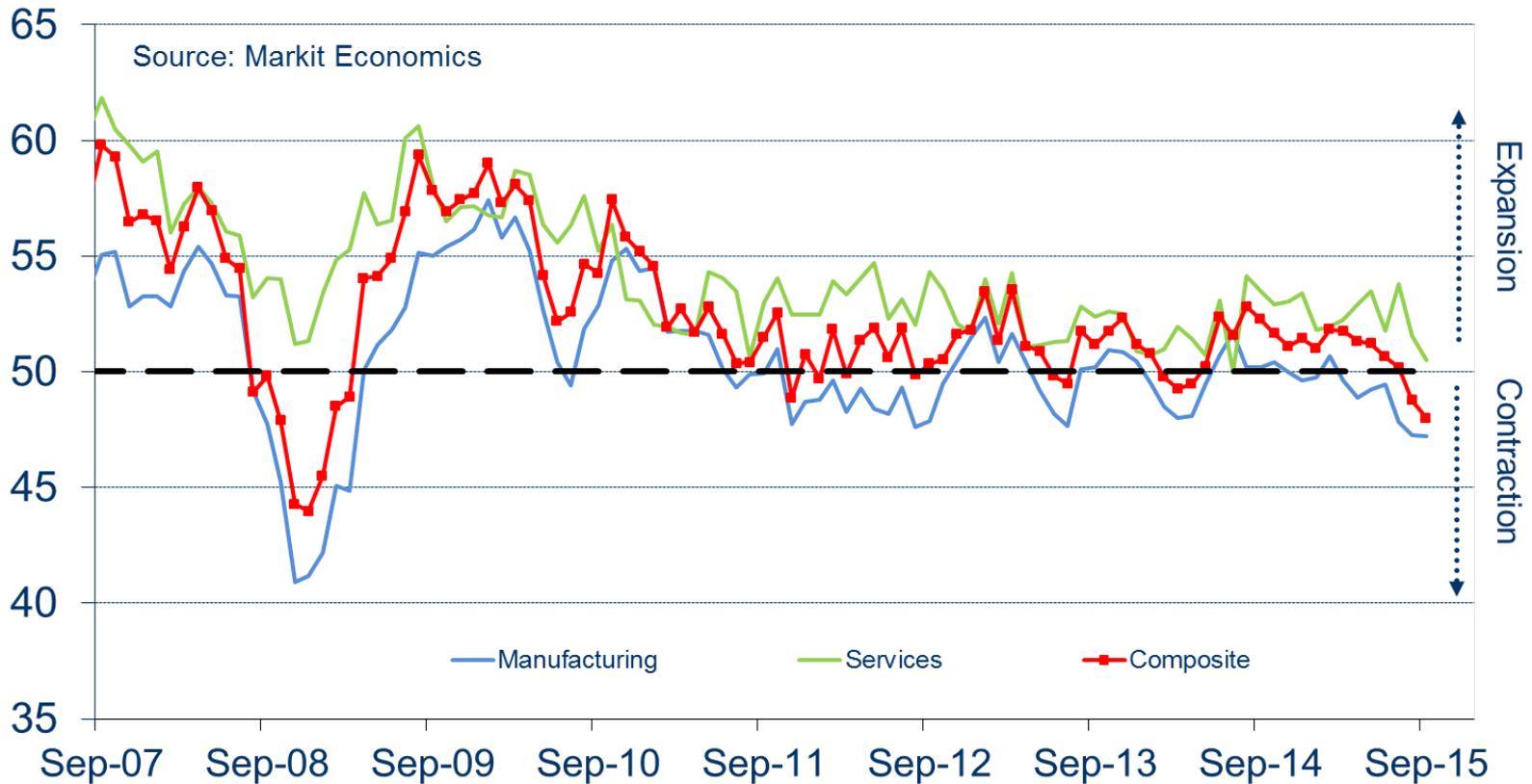
4m rolling average growth, YoY %



Source: RBS Macro Credit Research, CEIC, Bloomberg
 Note: All the indicators are 4m rolling average except GDP growth YoY

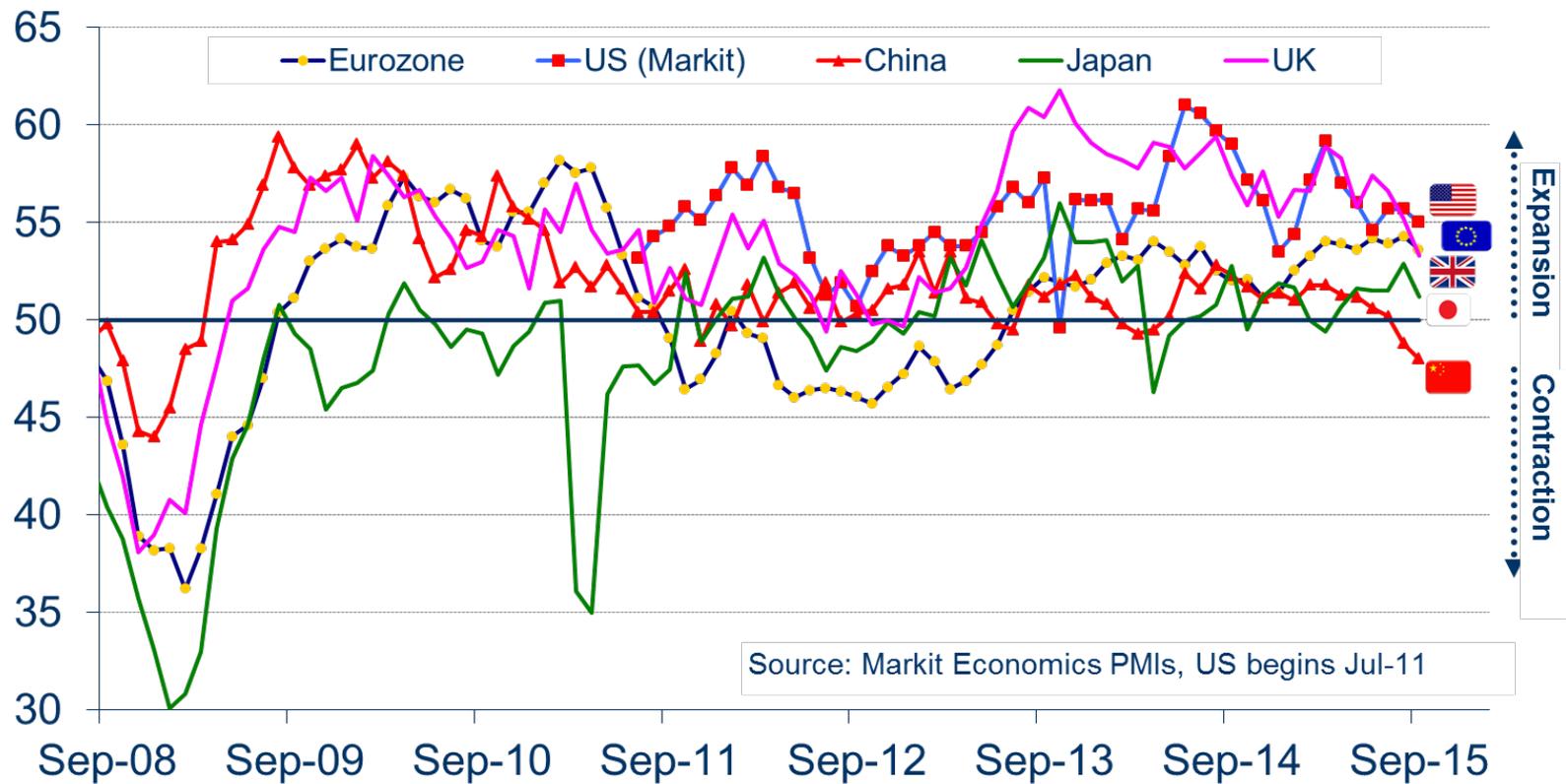
Chinese Composite PMI hits its lowest level since Jan-09

China PMIs



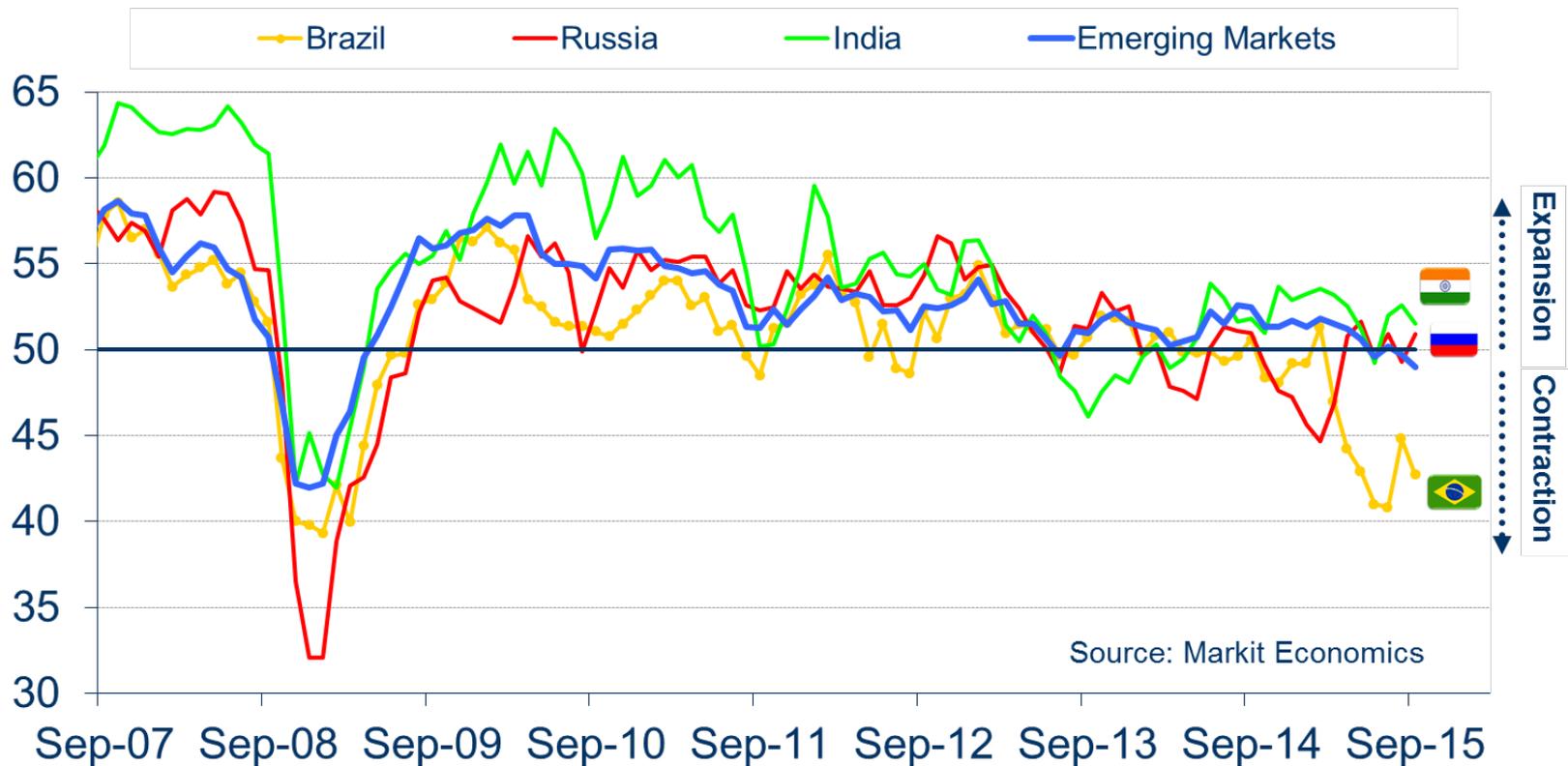
Composite PMIs showing a deterioration in growth

Composite PMIs (Manufacturing & Services ** Excludes Construction**)

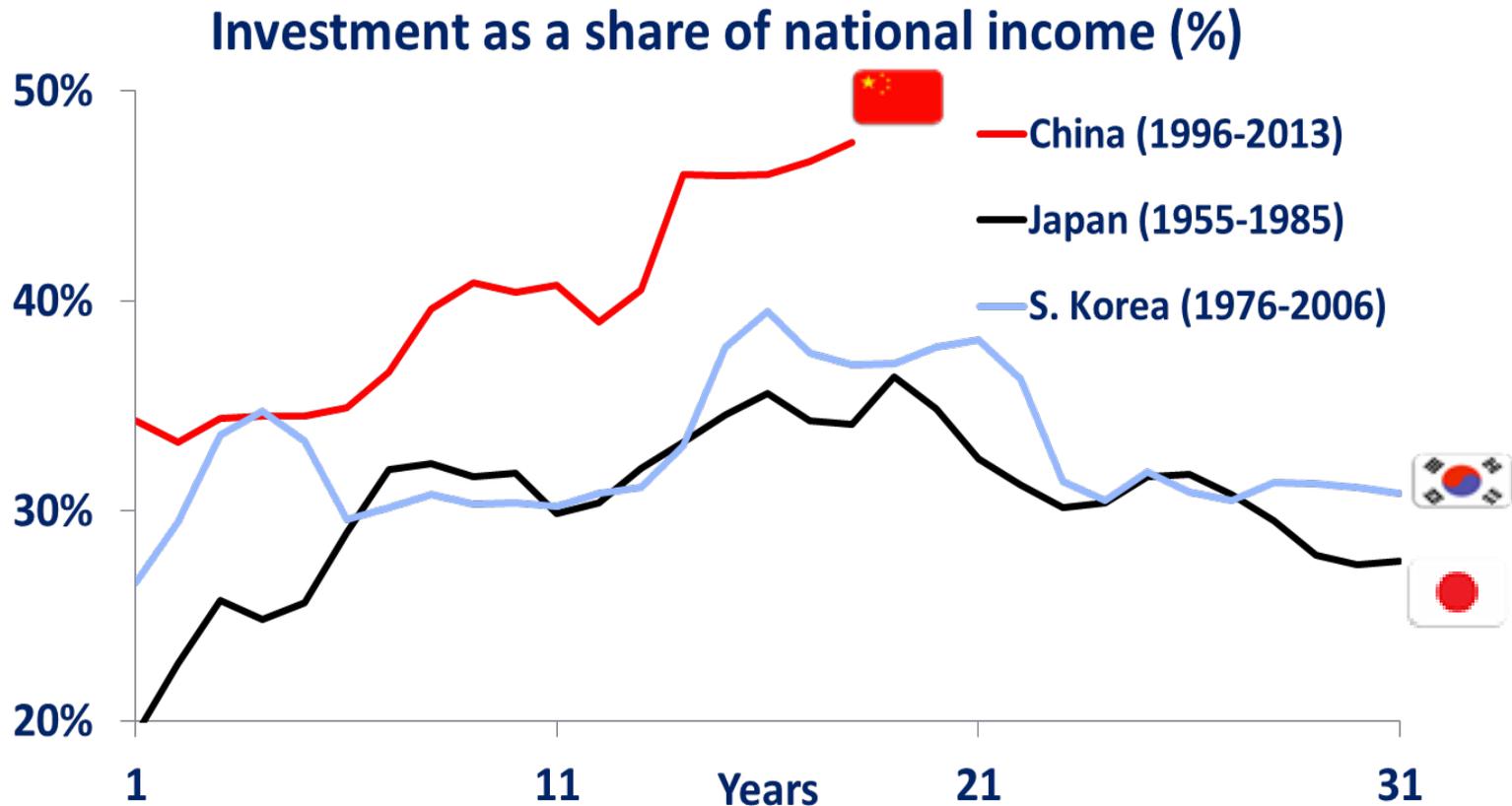


Alongside China, the PMIs for the Emerging Markets, have been signalling a slowdown / contraction

Composite PMIs (Manufacturing & Services ** Excludes Construction**)

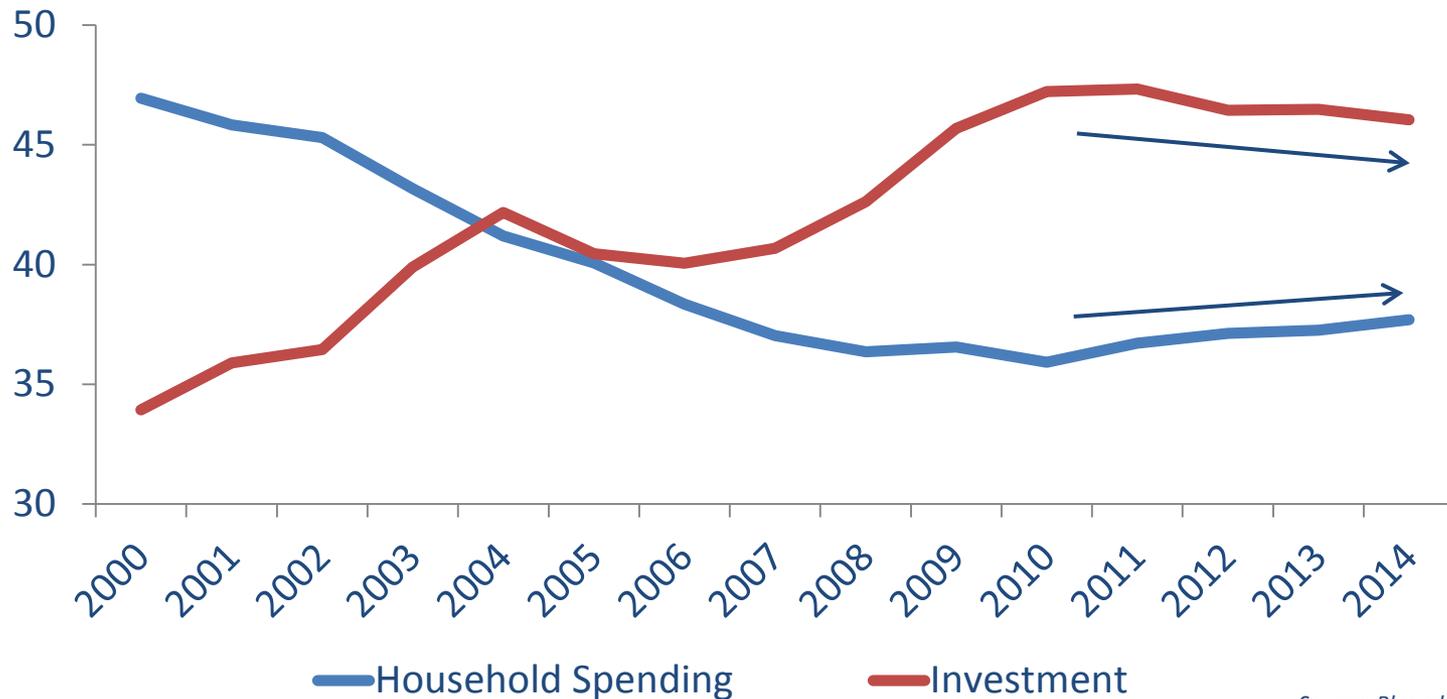


China's slowdown has been on the cards for quite a while.... what goes up must come down



But household consumption has to go up a lot more for China to rebalance its economy

China - Investment & Household Spending as % of GDP

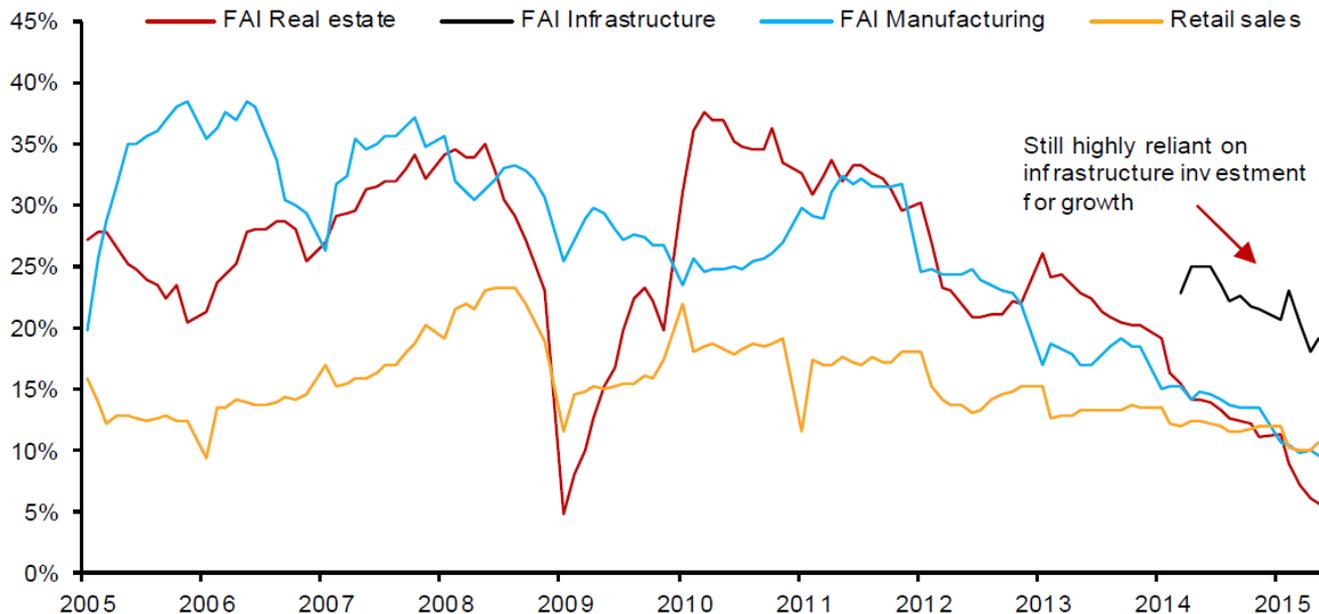


Source: Bloomberg

China is rebalancing away from investment to consumption within a two-speed economy

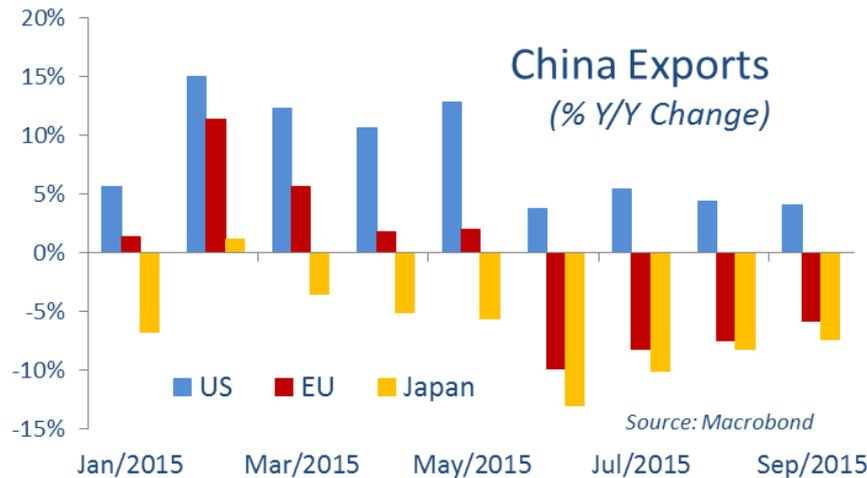
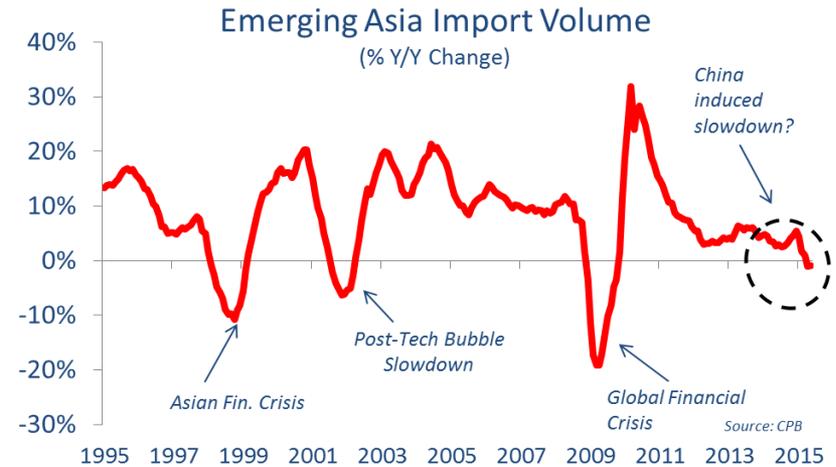
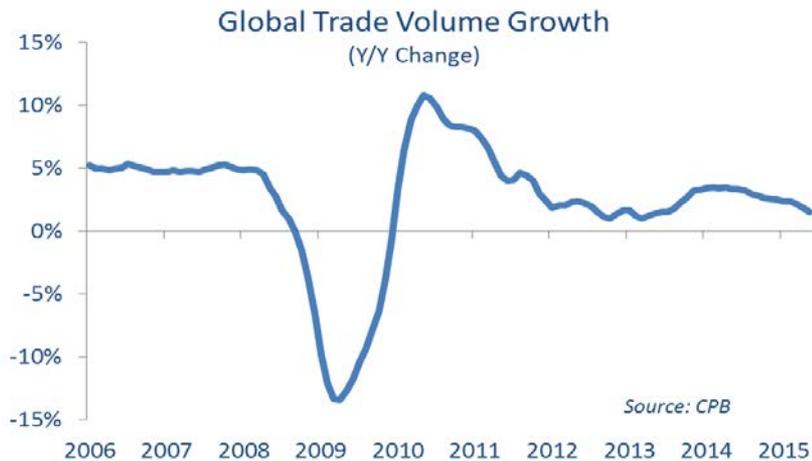
China: Shifting from a debt-fuelled, investment-driven growth model

Fixed asset investment & consumption, YoY growth



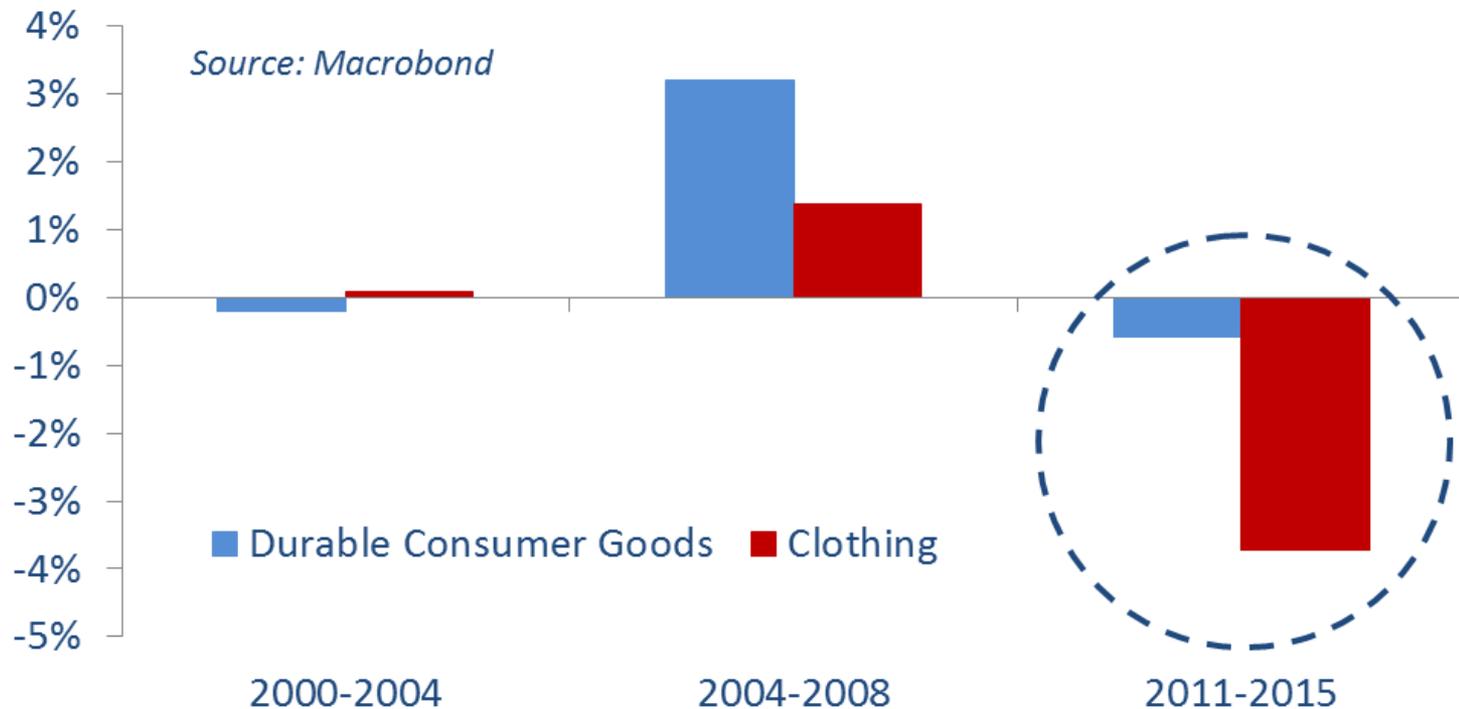
Source: RBS Macro Credit Research, Bloomberg

A big reason why world trade is so bad right now

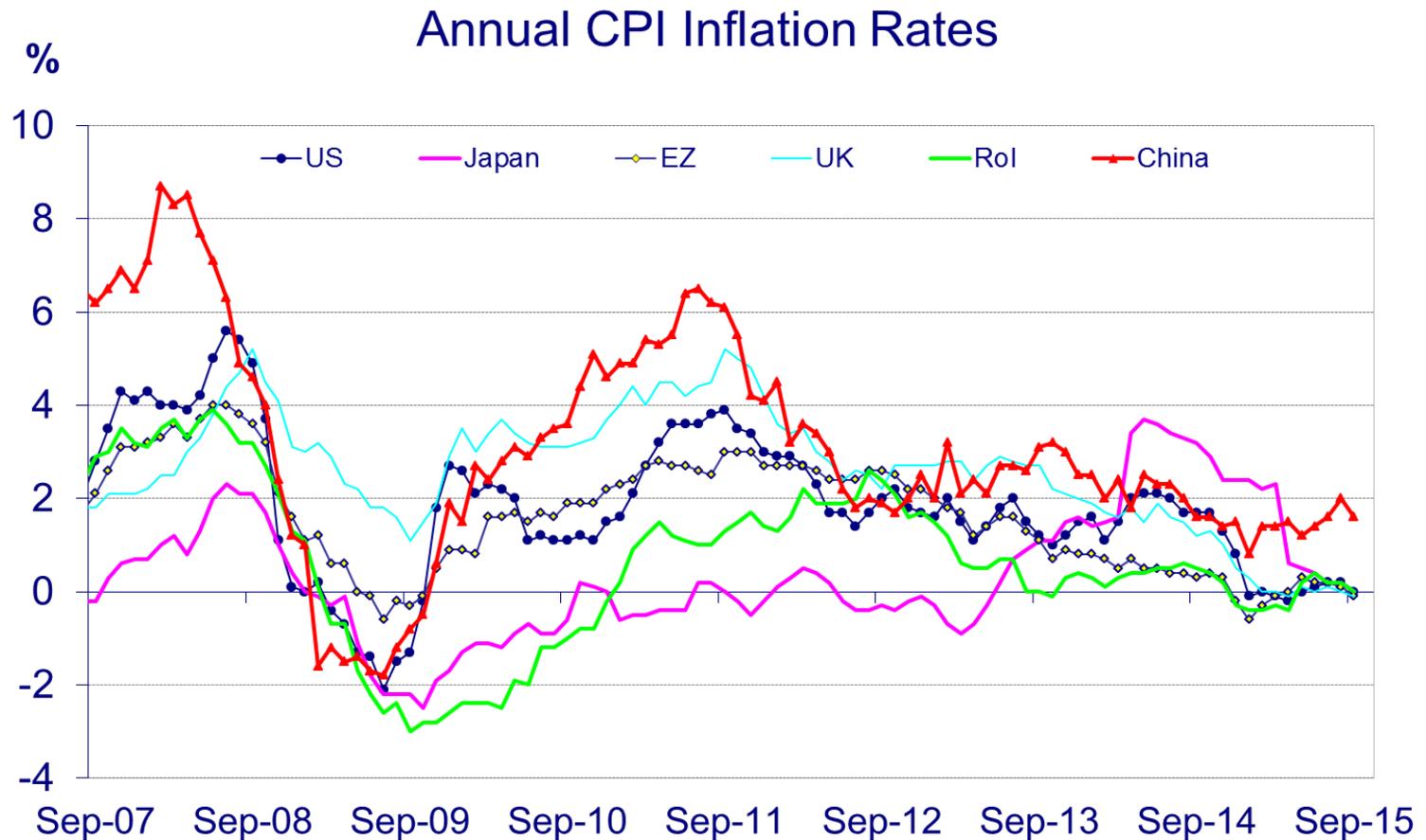


China is now exporting more disinflation / deflation than it did before the last crisis

China Producer Prices - Consumer Goods & Clothing
(Average Monthly Y/Y Change)



China is now exporting more disinflation / deflation than it did before the last crisis



The UK steel industry's exposure to China has recently hit the headlines

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Steel crisis 'strikes to heart of UK manufacturing'

Fears for tens of thousands of jobs in manufacturing as steel crisis sends shockwaves through British industry

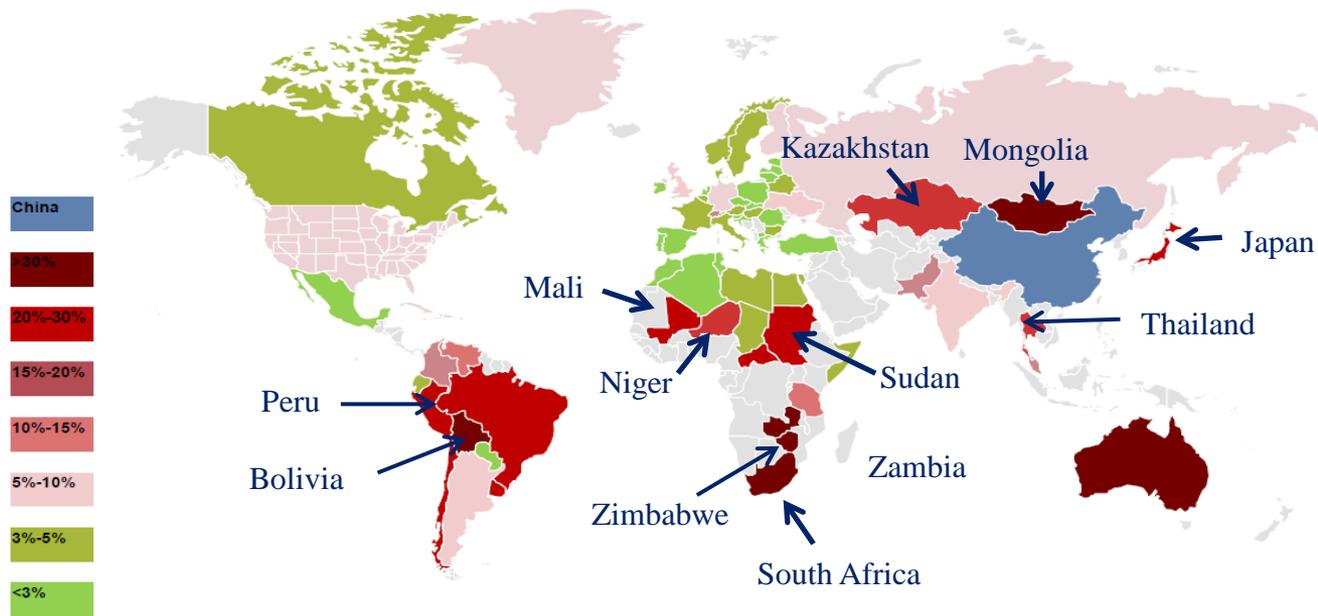


Tata Steel has confirmed plans to cut 1,200 jobs Photo: PA

Export markets exposed to China

EM, Japan, Australia, Germany and the US are linked to China

Exports to China, % total exports

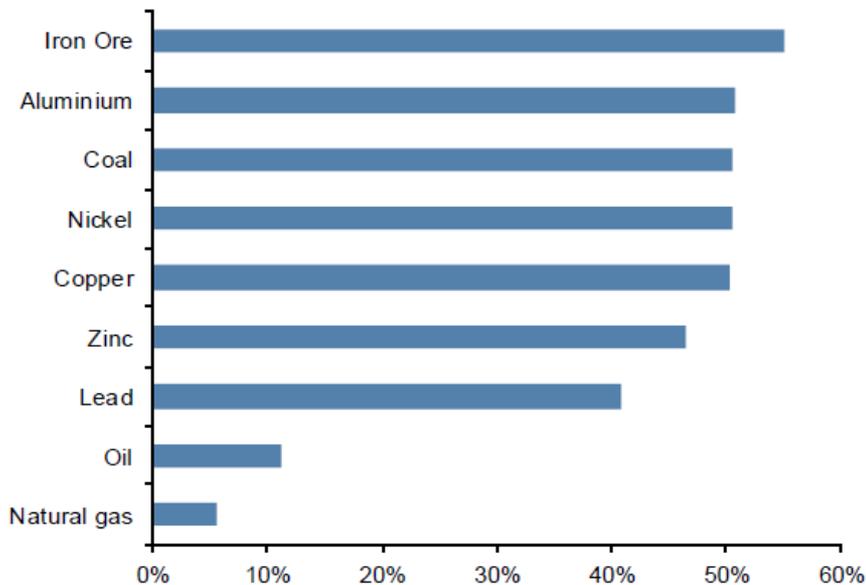


Source: RBS Macro Credit Research, Bloomberg

**China accounted for just 1.5% (£94m) of Northern Ireland's manufacturing exports (£6.1bn) in 2013/14*
China was the UK's 6th largest export market in 2014 (after US, Ger, Neth, Fra & RoI) with 5.3% of total*

The China contagion: Commodity exporters are more vulnerable

China accounts for half of global metal consumption
 China's commodity consumption, % of world total



Source: RBS Macro Credit Research, WBMS, The World Steel Association, BP, EIA, Bloomberg

Bloomberg Commodities Index hit a near 16-yr low



Impact on N.Ireland? 40% of the world's mobile crushing and screening equipment is made in NI!



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Northern Ireland is a recognised centre of excellence in the design and manufacture of materials handling equipment.

It is used in a broad range of applications including construction, quarrying, mining and recycling.

We have one of the world's most successful clusters of engineering companies developing innovative solutions that are exported globally.

40% of the world's mobile crushing and screening equipment is made in Northern Ireland

Machinery manufactured in Northern Ireland is sold to customers worldwide for applications as diverse as iron ore mining in India, road construction in Peru, diamond exploration in South Africa and sand washing in the Arabian Gulf.

Among areas of particular expertise are mobile screening and crushing machinery – as well as bespoke equipment for the increasingly important recycling industry. International names with a manufacturing presence in Northern Ireland include **Terex**, **Caterpillar** and **NACCO** (USA), **Sandvik** and **TESAB** (Sweden) and **McCloskey** (Canada).

These companies have been operating successfully in Northern Ireland for many years, supported by a comprehensive and competitive supply chain. As a result, we have a resource of skills, knowledge and experience in materials handling which encourages and facilitates market-led innovation.

Our two world class universities, Queen's University Belfast and the Ulster University, along with our colleges have strong engineering centres which work with companies on R&D and new product development.

Materials Handling

Search the company directory

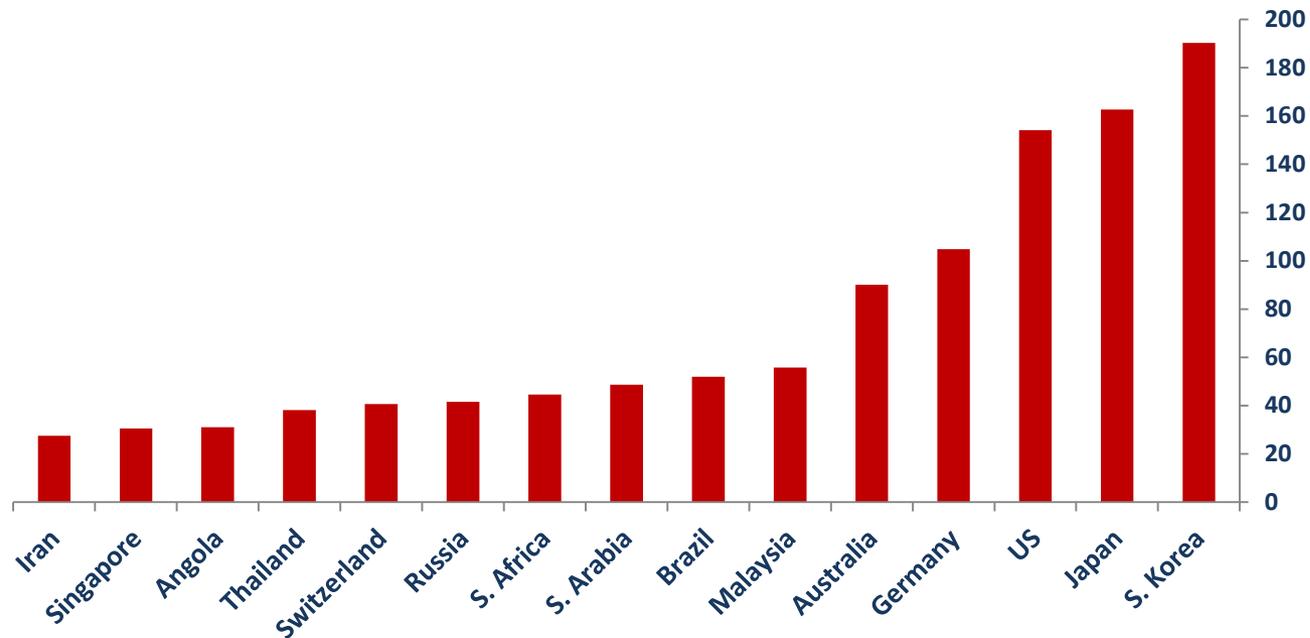
40%

of the world's mobile stone crushing & gravel screening equipment is made here



S.Korea, Japan, the US, Germany & Australia are China's top 5 importers

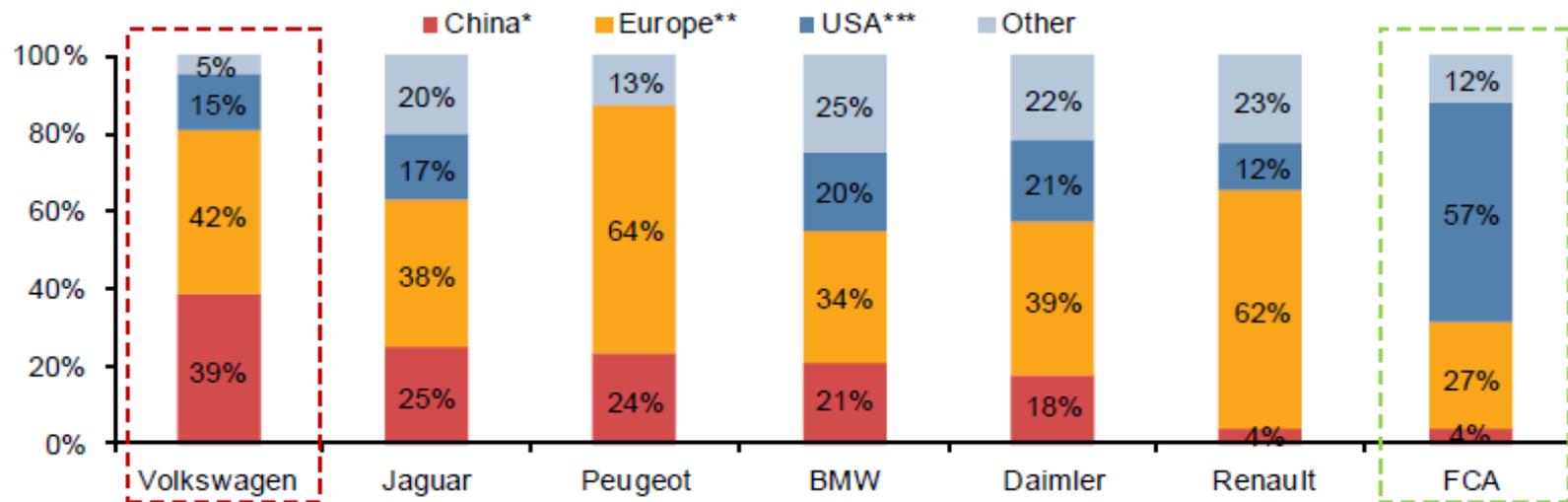
China Imports by Country
(2014, \$Bn)



Source: Bloomberg

German car industry is exposed notably VW

Volkswagen is the most exposed to China, while FCA has higher DM exposure
 Automobile deliveries (units), % of global exposure



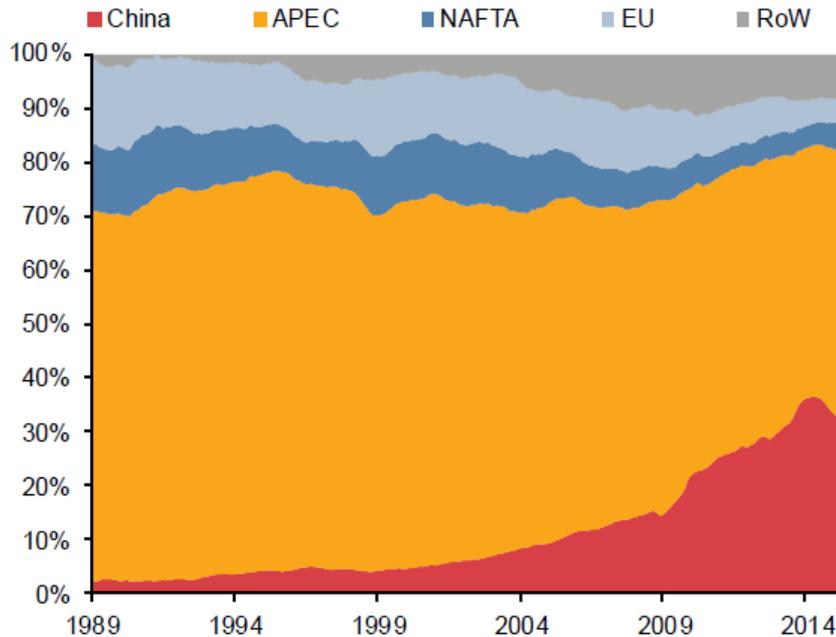
Source: RBS Macro Credit Research, company presentations H1 2015. *For Peugeot, China % includes sales in SE Asia, for Renault and FCA, China % includes sales to other Asia-Pacific countries. **For FCA, Europe includes sales to other EMEA countries. ***For BMW, USA % includes sales to Canada; for FCA and Daimler, USA includes sales to other North American countries.

When China sneezes, Australia will catch a cold

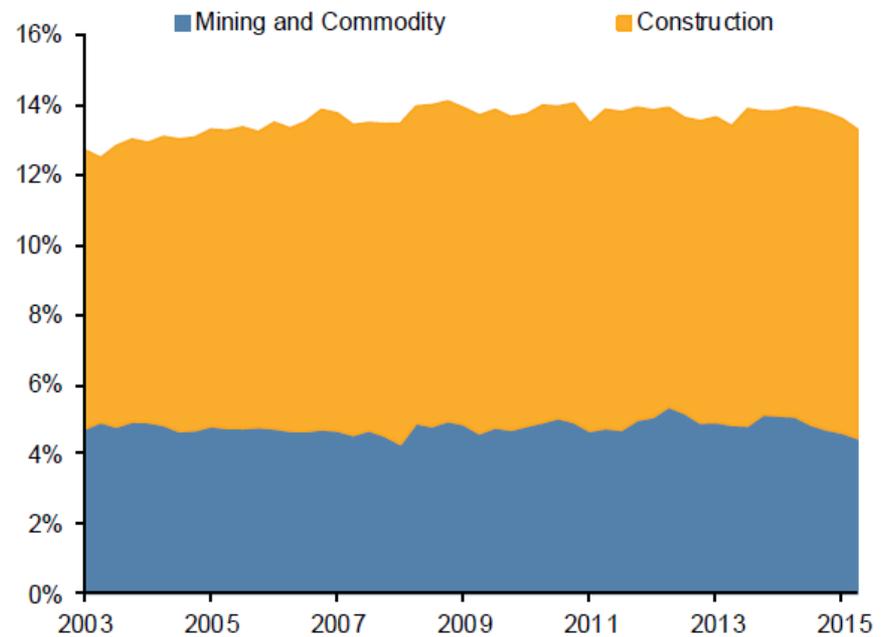
Australia is at risk from a slowdown in EM, falling commodities prices and capital outflows

Australia is highly dependent on China and Asia-Pacific
Merchandise exports by destination, % total

Employment in export industries is falling
Employment in mining and construction, % total labour force



Source: RBS Macro Credit Research, Australian Bureau of Statistics



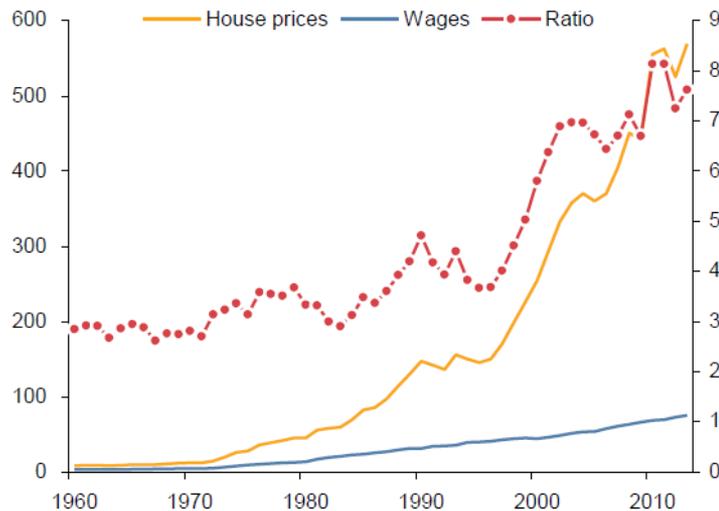
Source: RBS Macro Credit Research, Australian Bureau of Statistics

What's up Down Under?

Australia's property market is overvalued

House prices are rising quickly

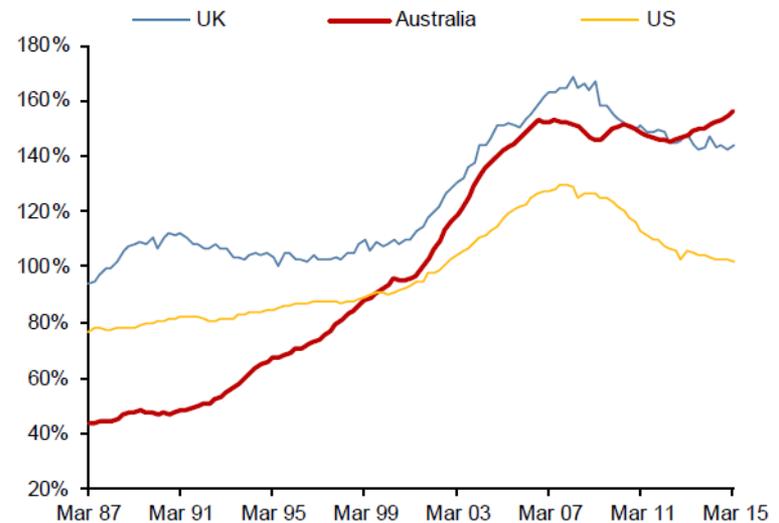
Melbourne median house prices vs wages, AU\$000 and ratio



Source: RBS Macro Credit Research, Australian Bureau of Statistics, REIV

Households are more levered than the US and the UK

Household debt to disposable income ratio



Source: RBS Macro Credit Research, IMF

Emerging Market Crunch: China Slowdown & Contagion Risk

“The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought.”

Rudi Dornbusch

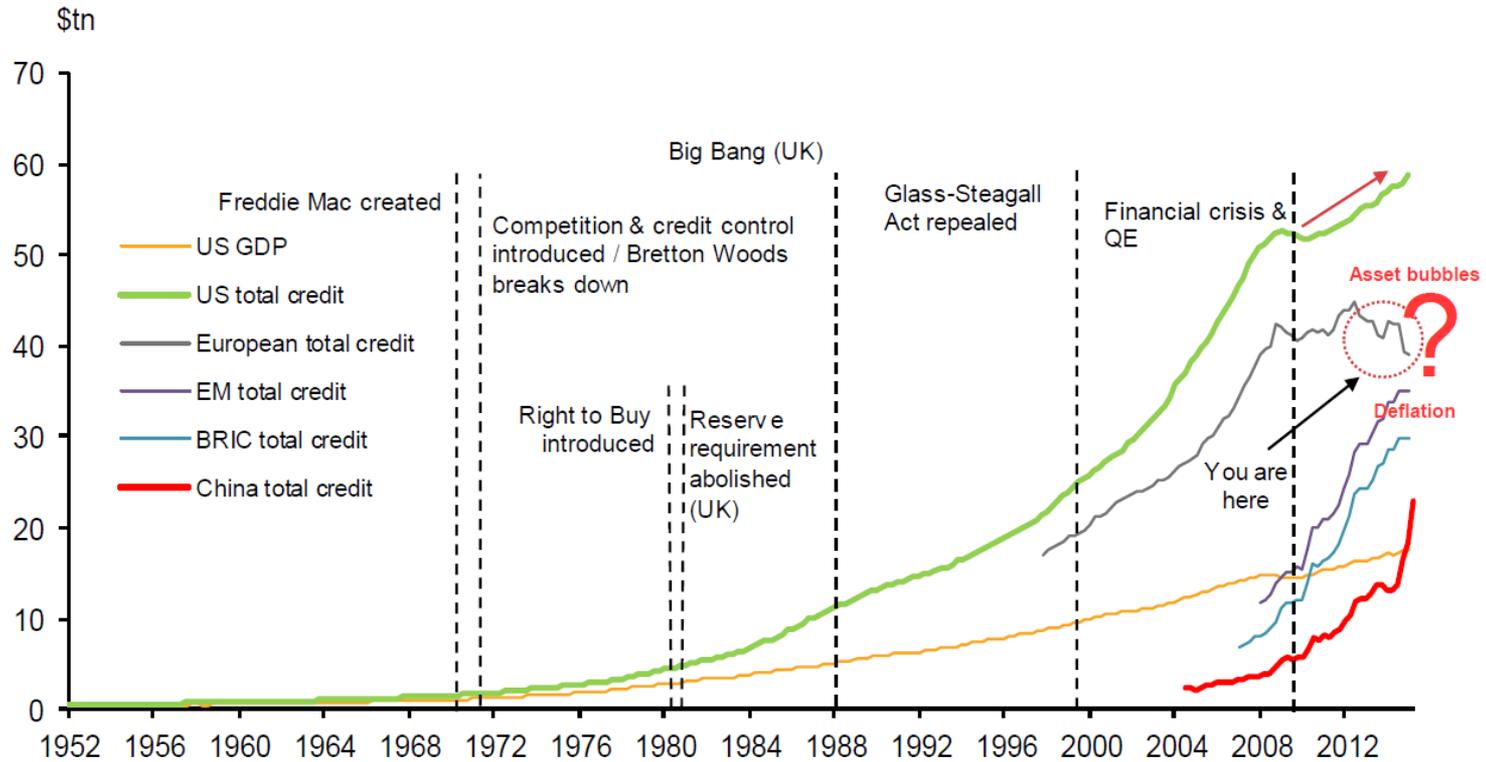
“In particular, these [EM] countries have exhibited signs of a build-up of financial imbalances, in the form of outsize credit booms alongside strong increases in asset prices, especially property prices, supported by unusually easy global liquidity conditions. It is the coincidence of the reversal of these booms with external vulnerabilities that should be watched most closely. A holistic view is critical. We are not seeing isolated tremors, but the release of pressure that has gradually accumulated over the years along major fault lines.”

Claudio Borio, Head of the Monetary & Economic Department,
Bank for International Settlements, 11 September 2015



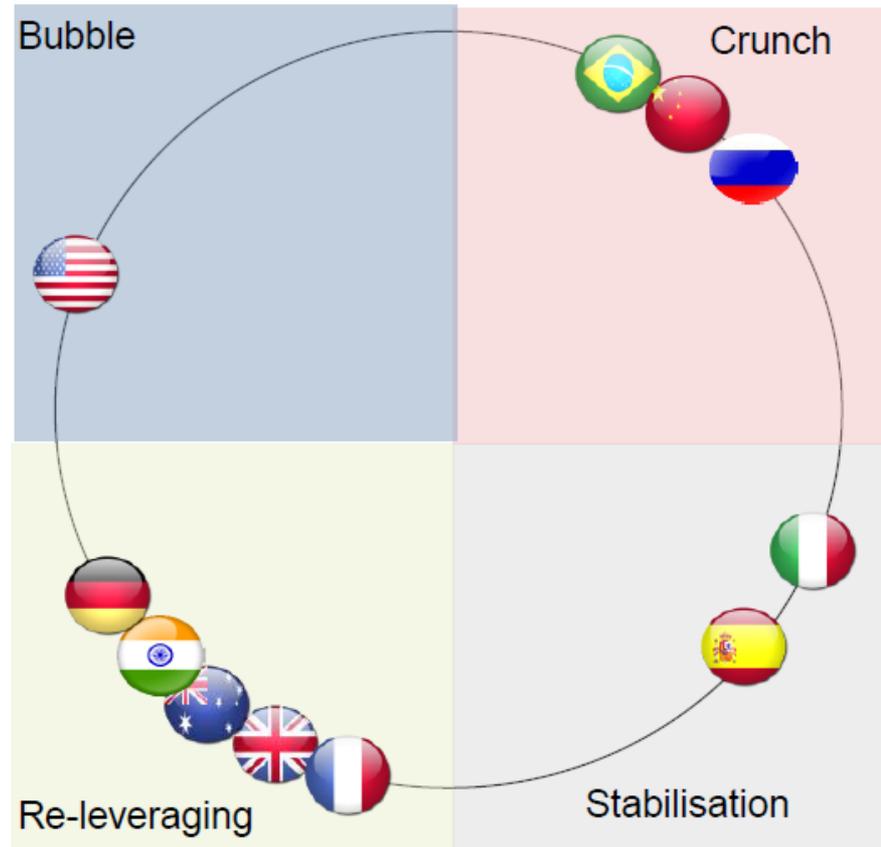
Credit (crunch) where credit (crunch) is (over) due?

The credit supercycle: The deleveraging EM never had



Source: RBS Macro Credit Research, ECB, FRED, Bloomberg

Emerging markets are facing a crunch



Source: RBS Macro Credit Research, Bloomberg

China's credit boom followed the GFC. How sound was that lending?

China - Credit as Share of GDP

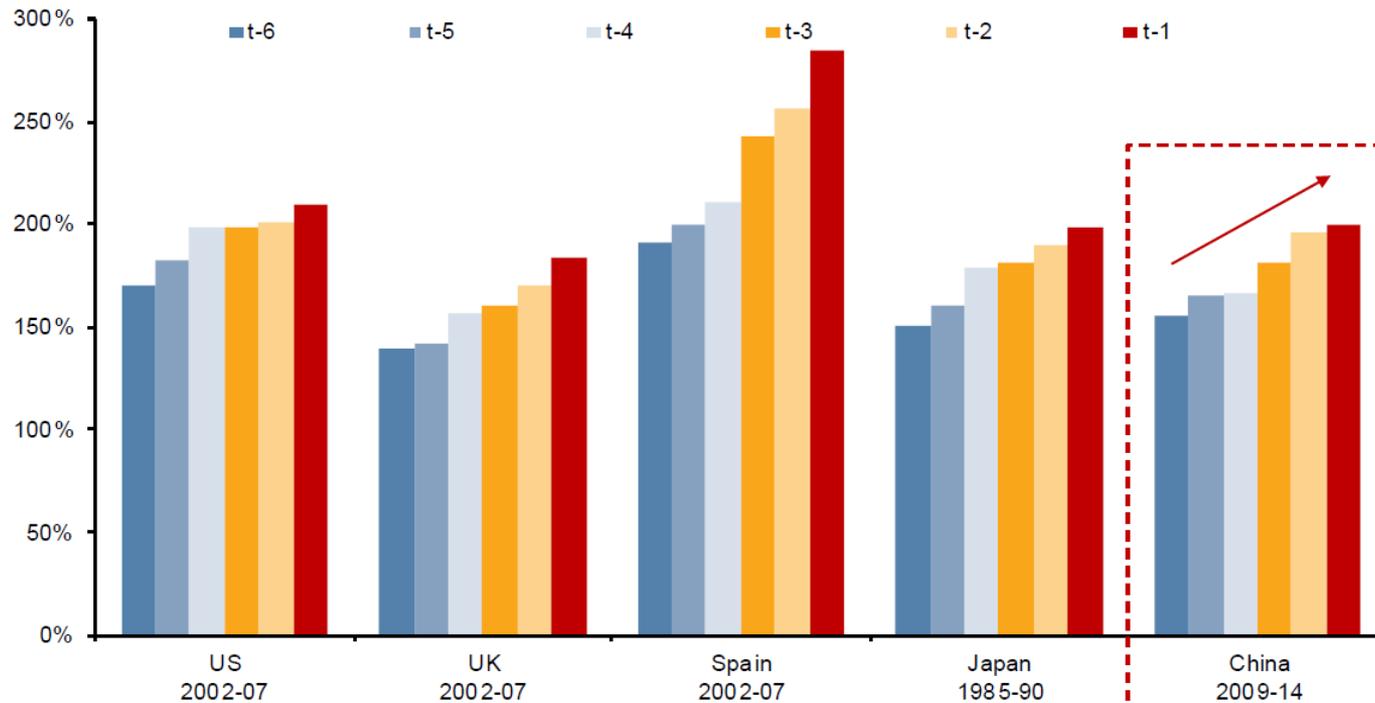


Source: Bloomberg

A sustained period of credit growth is always a bad sign

China: The bad omen of fast credit growth

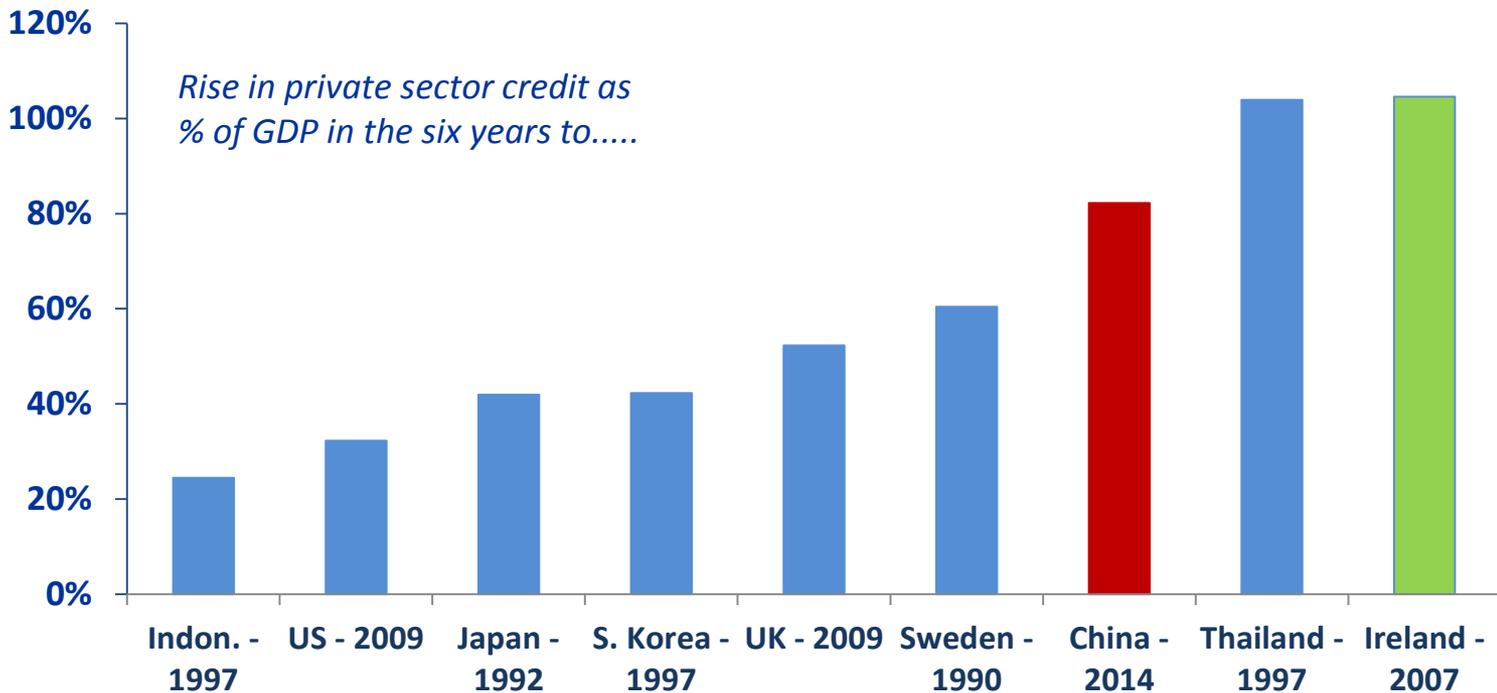
Credit as % of GDP



Source: RBS Macro Credit Research, Bloomberg, IMF, ECB

Financial crises are normally preceded by a period of private sector credit expansion. China fits that pattern.

The 'Financial Crisis 8' & China

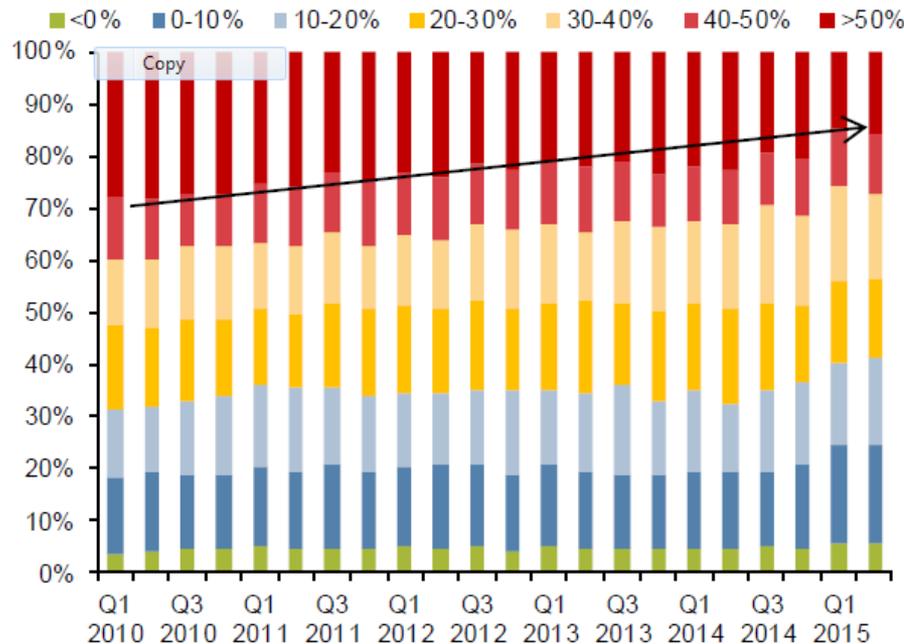


Source: Macrobond, IMF

Chinese firms: Debt is falling, but profitability is falling faster

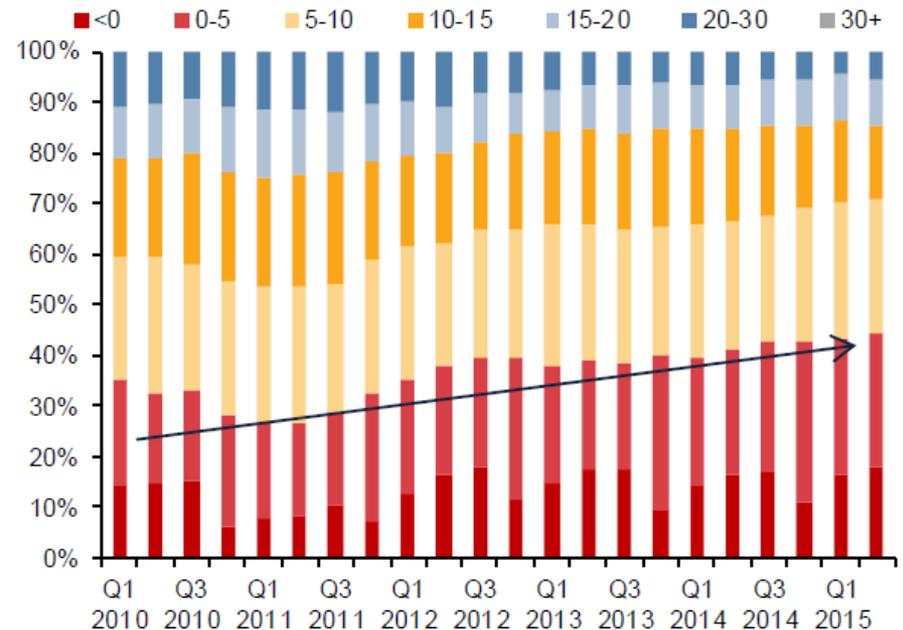
High levels of debt are falling

Distribution of total debt/total assets of companies (Shanghai Stock Exchange), % companies



Firms ROE has decreased

Distribution of RoE of companies in Shanghai Stock Exchange Composite Index, % of companies

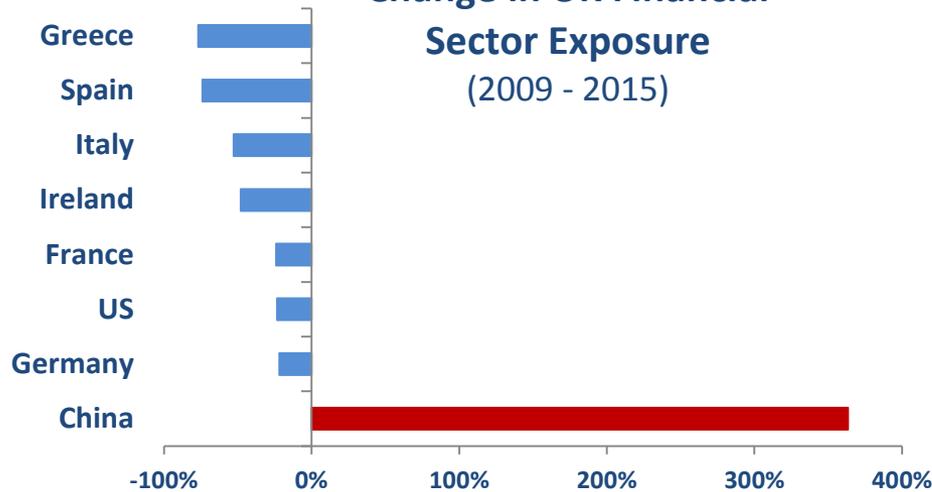


Source: RBS Macro Credit Research, Bloomberg

Source: RBS Macro Credit Research, Bloomberg

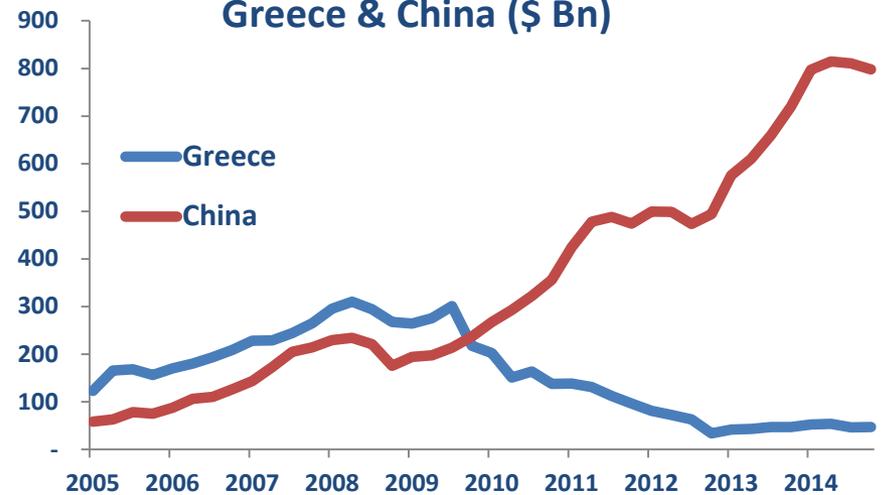
Financial crisis impact? Remember China is not Greece!

Change in UK Financial Sector Exposure (2009 - 2015)



Source: Macrobond, BIS

Global Banking Sector Exposure to Greece & China (\$ Bn)



Source: BIS

Conclusion

- The world is more exposed to developments in China & Emerging Economies than ever before
- China is the biggest manufacturer & exporter on earth
- The slowing Chinese economy is pulling other economies down with it
- Economies exposed to commodities & Chinese trade particularly vulnerable
- Bigger concern is not the economic slowdown but the risk of a financial crisis
- No country that has witnessed the expansion in credit that China has seen has avoided a financial crisis
- Credit boom occurred within China's unique political environment. Lending followed political criteria not economic
- China has plenty of firepower to deal with a crisis but policy response will be critical

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