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China's buoyant economy is not unsinkable

By Alan Wheatley
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BEIJING: China's growth is strong, its currency is rising and a huge stash of foreign reserves insulates the economy from the sort of external payments crisis that rocked Asia a decade ago.

But that is not keeping economists from playing "what if?"

What if China's export engine suddenly seized up? What if the resulting overcapacity exposed a new crop of bad bank loans? What if share and property prices plunged, sapping confidence and triggering capital flight that rattled banks and hit the yuan?

Unlikely, yes. Impossible, no.

Stephen Jennings, head of the Russian investment bank Renaissance Capital, said in Moscow that China's double-digit growth and soaring equities could drop so hard that it would make the 1998 emerging markets crisis look like a storm in a teacup.

"The 8.5 earthquake on the Richter scale that will affect all of us - to me it's China," Jennings said in a recent interview.

China has long defied the sceptics, but economists agree that the longer imbalances and liquidity build up because of the yuan's semi-fixed exchange rate, the greater the risks.

Nouriel Roubini, head of Roubini Global Economics and a New York University economics professor, pointed to a hard landing in the United States as a trigger for a possible China crisis.

The ensuing slowdown in China's growth could lead to a surge in bad loans, while a slump in share and real estate prices could wipe out enough wealth to dent residential construction.

"The risks are that these things at some point - not in the very short term - get out of hand and then become a serious macro and financial problem to manage," Roubini said.

China has spent as much as $500 billion since 1998 beefing up its banks, and its public finances are strong enough to rescue them again.

"Of course fiscal resources could be used to help the banks," Roubini said during a recent visit to Beijing.

"But at that point the risk is you get a credit crunch that has negative effects on the financial system and on the real economy regardless of the ability of the government to bail out the banks."

Eswar Prasad, a professor at Cornell University in Ithaca, New York, argued that an "explosive crisis" was unlikely but said he was concerned that China's "dysfunctional" financial system might not be robust enough to withstand a big shock.

Prasad, a former International Monetary Fund researcher, identified a sudden reversal of capital inflows - caused perhaps by a loss of confidence in the banking system or social instability generated by rising inequality - as a vulnerability.

Monetary policy is a country's first line of defense in the event of an economic shock. But China's dollar-linked exchange rate robs it of an independent monetary policy, Prasad said.

So if, say, Chinese households withdrew 10 percent of their bank deposits - about $200 billion - at a time of contracting economic demand, the resulting instability in financial markets could feed on itself unchecked.

"It's a potential risk. One wouldn't want to overstate the case," Prasad said. "But, in terms of thinking of scenarios, it's illustrative of the fact that even a small change in people's preference for holding banking deposits could, because of the fragilities of the system, become something much larger."

Amy Auster, head of international economics at ANZ Bank, said China was right to worry about capital flight, even though money is pouring in right now in anticipation of a stronger yuan.

"Should these expectations reverse - as they did when Australia floated its currency in the 1980s - the outflows of funds could prove too big for the banking system to bear."

The policy priority then is to make the banking system as watertight as it needs to be for capital to flow freely in and out of China, Auster said in a recent report.

"The longer this process takes, the greater the risk of vast leakages in the capital account that force greater volatility into interest rates and asset prices, and eventually an abrupt currency adjustment. This, in our view, is the greatest medium-term risk to growth in China," she said.

There is no shortage of other culprits that could derail China's economy, or at least force a radical retooling of its resource-intensive growth model.

One Beijing economist worries about the impact of a big spill of dangerous chemicals; others fear growing water shortages.

Yet not everyone is wallowing in doom and gloom.

Qing Wang and Denise Yam at Morgan Stanley name protectionism as the biggest threat, but they see only a small chance of a major policy-induced slowdown in the next few years.

"We expect the fundamental forces - including efficiency gains from structural reform, globalization, urbanization and industrialization - that have underpinned the strong secular trend growth in China over the past two decades will continue to drive robust growth for years to come," they said in a report.

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