



## The China Dimension of the Global Credit Crunch\*

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***Bank of China (BoC) revealed that including its Hong Kong branch, it had a total exposure of USD 10.3 billion.***

***With total assets of USD 770 billion, the Mainland BoC's exposure to asset-backed securities with sub-prime mortgages was reported to be USD 8.965 billion, of which 75% were AAA rated, and USD 682 million sub-prime mortgage-backed Collateralised Debt Obligations (CDO), of which 85% were AAA rated. The Industrial and Commercial Bank of China (ICBC), the world's largest bank by its latest market capitalisation, was reported to have an exposure of USD 1.23 billion, equivalent to 0.3% of its total securities investment. The BoC has set aside USD 150 million to cover any contingent losses while the ICBC did foresee a loss 'if calculated at the current market value of the securities', but the loss was not considered significant.***

***China banks and their relatively limited exposure to sub-prime markets seem to suggest that the situation is largely manageable.***

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*The so-called global credit crunch is not caused by too little credit, but by credit being too much and too loose. A vast proportion of the world's current account surpluses is accounted for by China. This has manifested in the largest ever foreign exchange reserve on the planet: USD 1.336 trillion, growing daily by some 20% a year. Most of this is invested in US Treasuries, exerting downward pressure on US and international interest rates.*

*China needs to save, to build up an adequate safety net for her looming aged population profile. On the other hand, the US, together with other developed countries, has comparatively less scope for infrastructural investment as consumption, rather than industry investment, is a key driver of the US economy.*

*In fact, the RMB has already been appreciating by about 5% a year. This will put more purchasing power in the hands of China's masses, including her huge peasant population. This will also serve to restore some balance between exports and consumption.*

*Another important part of the China dimension is capital flow or investment, both into and out of China. China is already one of the world's most open economies. International trade represents 75% of China's GDP, compared with 25 to 30% in the case of Japan, India and Brazil. Further liberalization is happening in her financial sector in compliance with WTO entry requirements.*

*There is a risk of a Chinese asset bubble as more and more money is piled on the less than ideally regulated property market. There is also irrational exuberance in her stock markets. As China's private investment outlets are still developing, it is uncertain whether these measures will be effective in dampening speculative or uninformed investment activities.*

When the sub-prime storm first started to brew, the Asian, and especially, the Chinese front was relatively calm. Many believed that most Asian banks, especially Chinese state-owned banks, tended to be more conservative in their operations. Moreover, most Asian countries, especially China, have strong foreign exchange reserves, robust economies, and generally undervalued currencies. So there was little to be unduly alarmed. I, for one, believed that China's direct sub-prime exposure was fairly limited.

So when the Bank of China (BoC) revealed that including its Hong Kong branch, it had a total exposure of USD 10.3 billion, alarm bells rang loud across the wires. Is the figure only the tip of an iceberg? How many other Chinese and Asian banks are affected? What are the repercussions, both domestically and internationally? Would these trigger a US and hence a global recession?

First the facts so far: With total assets of USD 770 billion, the Mainland BoC's exposure to asset-backed securities with sub-prime mortgages was reported to be USD 8.965 billion, of which 75% were AAA rated, and USD 682 million sub-prime mortgage-backed Collateralised Debt Obligations (CDO), of which 85% were AAA rated. The Industrial and Commercial Bank of China (ICBC), the world's largest bank by its latest market capitalisation, was reported to have an exposure of USD 1.23 billion, equivalent to 0.3% of its total securities investment. The BoC has set aside USD 150 million to cover any contingent losses while the ICBC did foresee a loss 'if calculated at the current market value of the securities', but the loss was not considered significant. Both banks revealed their exposures with their interim results, which showed strong profit growth. Nevertheless, this did not stop the BoC's shares falling by 8% on 25 August, later stabilising at 5.3% off. The shares of BoC Hong Kong also fell by 4%. On 27 August, the China Construction Bank, China's third largest bank, declared a sub-prime exposure of USD 1.06 billion, for which it has made a provision of USD 145 million. The exposure was less than CLSA's earlier estimate. The bank also announced robust profit growth of 47% for the first half of 2007, well beyond market expectations.

In the wake of the sub-prime fallout, there is no doubt a much greater aversion to risk amongst investors all around. But barring further unexpected revelations

or implosions, the huge assets and financial strengths of these China banks and their relatively limited exposure to sub-prime markets seem to suggest that the situation is largely manageable. This is in line with the conclusion of Fitch Ratings' teleconference review on 23rd August of Asset Backed Commercial Paper (ABCP) and Global Banks, which showed a global exposure averaging about 3% of assets.

However, considering how the sub-prime crisis was spawned in the first place and how it is playing out globally, there is much more to the China dimension than the impact on her banking system.

The so-called global credit crunch is not caused by too little credit, but by credit being too much and too loose. A vast proportion of the world's current account surpluses is accounted for by China. This has manifested in the largest ever foreign exchange reserve on the planet: USD 1.336 trillion, growing daily by some 20% a year. Most of this is invested in US Treasuries, exerting downward pressure on US and international interest rates. This provides an easy ride for the US economy (and US politicians), as lower interest rates are welcomed by businesses and private consumers famous in the US for their propensity for credit. So there is a vicious, or according to some, virtuous circle.

Additionally, cheap money fuels the housing market. And loose bank mortgage practices have allowed even the so-called 'NINJAS' (individuals with No-Income, No Jobs, and no ASsets) to borrow. Until the crunch came, consumers and house speculators were having a field day. They borrowed more on the inflated value of their original or new investment properties. Meanwhile, banks and finance houses packaged and sold the sub-prime debts in structured CDOs with a mixture of risks difficult to decipher except to the most astute. So the party of musical chairs has been merrily going on, until the music stops, if only for a while.

China is part of the so-called Three Billion New Capitalists (Clyde Prestowitz, 2005), who, along with India and a host of other industrializing countries across the globe, are bringing down world inflation rates with their extremely price-competitive mass consumer products. No doubt, China's energy-intensive industries and urbanisation are also driving up global energy and resource prices which may fuel inflation. But as of now, even when inflation sometimes threatens to rise, this seems more localised and sector-specific (food, housing, energy, etc as the

case may be). In any case, inflationary pressures look less likely to be malignant and sustained. This phenomenon likewise contributes to lower than expected interest rates, and consequently cheaper money.

The huge global economic imbalance is well understood. The US, as the largest economy, consumes too much and saves too little while China, along with other Asian economies, acts the other way around. It cries out to be adjusted. But the developing economies need to generate more and more jobs for their masses, especially those from the countryside, and there is no better substitute than manufacturing and off-shore services provision at this stage of their development process. They have to save more to invest in basic infrastructure for continuing urbanisation and export-oriented industrialization. China, in particular, needs to save, although perhaps not that much, to build up an adequate safety net for her looming aged population profile. On the other hand, the US, together with other developed countries, has comparatively less scope for infrastructural investment as consumption, rather than industry investment, is a key driver of the US economy. The US current account deficit at 7% of GDP means that the US consumes every year, in excess of what she produces, close to the entire output of Brazil, the 10th largest economy in the world (Debtor Nation, *The Rising Risks of the American Dream on a Borrowed Dollar*, Jonathan Shaw, Harvard Magazine, July-August, 2007).

Apart from certain vote-grabbing voices on Capitol Hill, few educated observers blame the US current account deficit entirely on the undervalued Chinese currency. US consumers are more likely to turn to other developing countries' substitutes if Chinese imports should become less price-competitive. For China, before her financial system becomes more developed, undue haste in RMB appreciation is likely to attract unwelcome speculation and cause massive shocks to her and even the world's economic stability. The other side of the coin is for China to grow her consumer economy faster, so that she could import more from the US.

In fact, the RMB has already been appreciating by about 5% a year. This will put more purchasing power in the hands of China's masses, including her huge peasant population. This will also serve to restore some balance between exports and consumption. Indeed, China is witnessing a rapidly expanding middle-class

with changing lifestyles, embracing local and foreign brands. They are not only in China's glitzy mega-conurbations but also in second and third-tier cities and towns. Taking into account gradual RMB appreciation, the USD size of China's consumer economy is expected to grow to 90% of the US by 2014, with double the US annual incremental growth. The consumer pendulum is beginning to swing towards China (The Rise of the Chinese Consumer – Theory and Evidence, Jonathan Garner, 2005).

Another important part of the China dimension is capital flow or investment, both into and out of China. China is already one of the world's most open economies. International trade represents 75% of China's GDP, compared with 25 to 30% in the case of Japan, India and Brazil. Further liberalization is happening in her financial sector in compliance with WTO entry requirements. Her largest state-controlled banks now take in strategic foreign equities. The ICBC has raised USD 19.1 billion in the world's largest single international IPO and now ranks amongst the world's top ten banks. China's Qualified Foreign Institutional Investors (QFII) and Qualified Domestic Institutional Investors (QDII) schemes are being expanded to provide greater scope for foreign institutional funds to invest in the A-share market and for China-based funds to invest outside Mainland China. Indeed, China has just announced a relaxation to allow Mainland citizens to invest directly in Hong Kong's stock market, which has caused an euphoric rebound of the Hang Seng Index. This should facilitate China-related M&As and other corporate and private investments.

Moreover, China's stock markets are becoming much more energetic in recent months as what used to be non-tradable shares are being made tradable. Lehman Brothers, in their Global Economics alert dated 27 August, highlighted that China's stock market capitalization has now reached 100% of GDP. Indeed, while the world's major stock markets including those in Asia tumbled as the sub-prime crisis unfolded, the Shanghai Composite Index remained hardly unnerved.

China is setting up a state foreign exchange investment agency (a la Singapore's Temasek) to manage initially up to about USD 200 billion of her gigantic foreign currency reserve. Part of China's sovereign wealth is already invested abroad, for example, in a 10% stake in Blackstone and more recently in a minority stake in

Barclays, which, depending on circumstances, could rise from 3.1% to 8%. In the light of the sub-prime turmoil, China is likely to exercise extra care in such investments in future. Nevertheless, both the inherent instability of the China/US financial imbalance outlined above and the risks of China's huge exposure to the US Dollar are poised to induce a more diversified investment strategy for her hard-earned foreign exchange reserve. I have called for some of such funds (along with the petrodollars) to invest globally in responses to Climate Chaos, especially in energy efficiency (China and the Middle East: an Eastern Alchemy for Global Harmony, ATCA, 17 February, 2007).

Nevertheless, China's capital markets are still relatively underdeveloped, dominated by state-directed or sovereign funds. Private corporate debt represents only 1% of GDP, compared with 145% in the US (McKinsey Quarterly, 2006). Pending the maturity of China's capital market, we are seeing an increasing flow of Chinese corporations seeking to internationalize and to raise funds by listing in the world's major stock markets in Hong Kong, London and New York. This is China's 'Going-out' strategy for her companies to better their international business skills and to help build China's global brands.

The liberalization and further development of China's financial market, the 'Going-out' corporate strategy, and the gradual appreciation of the RMB should pave the way for the eventual international convertibility of the Chinese currency. If that happens, it will remove a favourite bone of contention with China's major trading partners and fully integrate China into the global financial mainstream.

What is more, we are also seeing the dynamic growth of inter-regional trade in Asia, of which China, along with Japan, Korea and the ASEAN countries, is playing a leading role. On 25th August, the ASEAN countries struck a free-trade deal with Japan, likely to be signed as early as November. This is expected to be followed by a similar deal with South Korea in 2008, Australia and New Zealand in 2009, China in 2010 and India in 2011, according to ASEAN's secretary-general. A report from the Eminent Persons' Group at the recent Asian Development Bank at Kyoto suggests that by 2020, Asia would account for one-third of global trade compared with the US's share of one-seventh.

The above developments should provide ample food for thought for institutional investors, private equity houses, hedge funds, venture capital providers, and asset/wealth management players. In face of increasing global financial uncertainties, including the current sub-prime crisis, China's vast economy with sustained dramatic growth over two decades, underpinned by a strong currency set to appreciate over a long-term trajectory, is a powerful investment attraction.

Naturally, China is no bed of roses. Apart from the host of problems I have outlined in my previous submission (ATCA, 29 July, 2007), there is a risk of a Chinese asset bubble as more and more money is piled on the less than ideally regulated property market. There is also irrational exuberance in her stock markets as taxi-drivers and street hawkers are checking their mobiles for the latest stock prices. Having reduced the interest tax on bank deposits, the People's Bank of China has just increased the one-year deposit rate by 27 basis points to 3.6%, for the fourth time this year. There are warnings of further monetary tightening if required. As China's private investment outlets are still developing, it is uncertain whether these measures will be effective in dampening speculative or uninformed investment activities.

For the China dimension to be a force for good in the global financial markets, the world should continue to engage China constructively. Her financial services should continue to benefit from the best practices of the West, especially openness, transparency, corporate governance, and management standards including risk assessment, pricing and control. Her sovereign and private funds need to be welcomed better, and assisted in the global market place. She needs high technology to help her innovate and continue to move up the global value chain. She needs international cooperation in improving her energy efficiency and in tackling her gigantic environmental problems. She needs to continue developing her rule of law and her civil society.

As China's middle-class continues to expand and as the RMB continues to appreciate, albeit gradually, she is poised to import and consume more, which should go some way in ameliorating the US-China economic imbalance. In the light of the sub-prime crisis, she is also set to diversify her foreign exchange

reserve prudently. As her financial markets open up, China may also offer increasing investment opportunities for the world's excess liquidity, hopefully subject to better-regulated risk pricing. It may be too early to tell how long the sub-prime storm will continue. But it is hoped that the China dimension is not arrested by rising protectionism or by paranoia of a Rising China, borne of uneducated fear, misconceived prejudices or shallow understanding.

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