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Commercial and Regulatory Response to Current Financial System Turbulence:

Causes of and Responses to Current Financial Turbulences:
Viewpoints of Commercial Banks in China

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The opinions expressed in this paper are those of the author, and not necessarily those of the bank

Summary

Up to now, the direct impacts of sub-prime crisis on China banking sector is very limited, however, the indirect impacts shouldn't be under-estimated. The real challenge ahead is the global macro-economy imbalances and its consequences on domestic economy. Asset bubbles, higher inflation expectations, funding constraints of SMEs, and the uncertainties of manufacture sector are all intertwined with each other. Such a difficult situation requires the banking sector to be more cautious and more pro-cyclically.

1. Chinese banks have largely avoided the impact of the credit crisis

Sub-prime mortgage crisis began with the bursting of the US housing bubble and high default rates on “sub-prime” and adjustable rate mortgages (ARM). Foreclosures accelerated in the United States in late 2006 and triggered a global financial crisis through 2007 and 2008. During 2007, nearly 1.3 million U.S. housing properties were subject to foreclosure activity, up 79% from 2006. Major banks and other financial institutions around the world have reported losses of approximately U.S. \$435 billion as of July 17, 2008.

Undoubtedly, this crisis is not solely a domestic problem—as was called initially, in contrast, the crisis quickly spread throughout the world. Because of the global economy, and the huge Sub-prime “pool” of mortgages that was bought by investors world wide, the International Monetary Fund (IMF) “says that the worldwide losses stemming from the US sub-prime mortgage crisis could run to \$945 billion.” It has yet to be seen if the US's stimulus plan will be enough to help the global economy too.

Unlike their counterparts in international financial markets, domestic banks in China

haven't suffered a significant loss from this crisis. The Bank of China (the #2 bank in China) announced in August of 2007, that it holds \$9.7 billion dollars of US Sub-prime debt. At the end of last year, this number was \$10.63 billion dollars. And as of March 31, 2008, the bank wrote off \$1.5 billion dollars of US Sub-prime debt, less than 20% percent of its 2007 net profit.

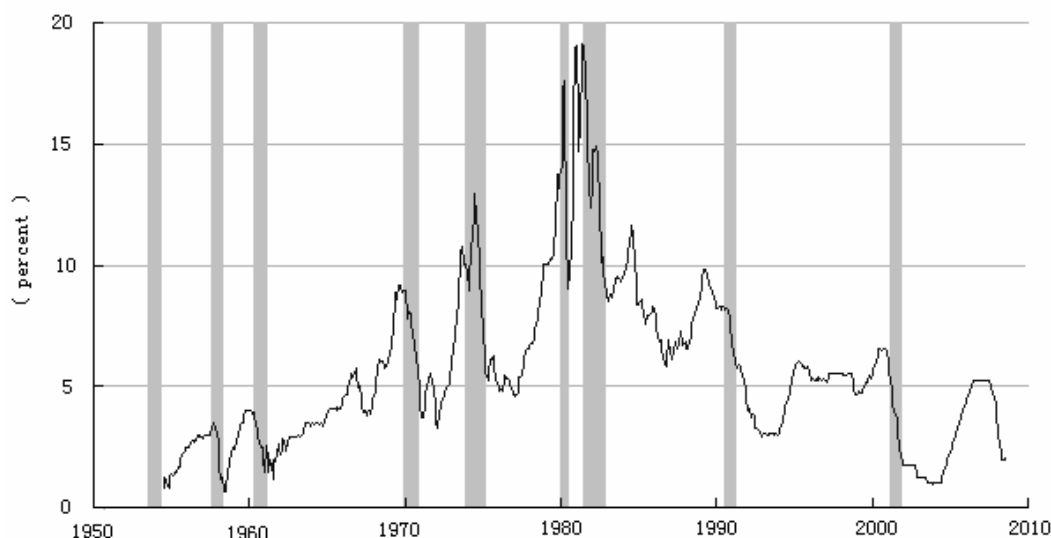
No signs indicate that the loss will develop further even after the most worried two issuers, Fannie Mae and Freddie Mac, are taken into consideration. Although it is said that China government is amongst the top five foreign holders of Freddie and Fannie long-term debt, the banking sector's holdings is of relatively small size. Bank of China said in late August it owned US\$7.5 billion in Fannie and Freddie bonds after cutting its holdings by about 25 percent, just 1.5 percent of its total holdings. ICBC, the country's biggest commercial lender, said in late August it owned US\$465 million in Fannie and Freddie debt, plus US\$2.2 billion in mortgage-backed securities issued by the two companies. China's No. 2 commercial lender, Construction Bank of China Ltd., said it owned US\$2.5 billion in Fannie and Freddie bonds, plus US\$695 million in mortgage-backed securities issued by the two lenders. All of them have set aside reserves for possible losses on sub-prime mortgage debt.

Is it a comfortable situation? It depends on which side you take a look. The key point is that, besides Bank of China, very few China banks have ever built up a strong presence abroad, and their participations into international markets are very limited. Since the capital account is of strict control by government, commercial banks in China are not allowed to fund and invest overseas freely. The major channel of their funding in foreign currency is domestic FX deposits, whose volume is quite small. This explains why the exposure to sub-prime crisis is limited.

2. The imbalance of US economy and its impact on China economy

It is well recognized that the US has experienced the longest growth path since World War II. However, it is also noticed the long lasting growth was fuelled by lower interest rates. As figure 1 indicates, the effective federal funds rates have been on downward track since the middle of 1980s. No wonder that when the sub-prime loans crisis burst out, Alan Greenspan was immediately under fire. One accusation against him is that the Fed lowered interest rates too fast between 2001 and 2003, but maybe more importantly, that after that it kept a 1% interest rate too long and raised it only in 2004, and slowly, thus fuelling the bubble in the housing market by making financing the purchase of a house very cheap. These critics suggest that once it was possible, the Fed should have raised interest rates faster in order to avoid an overheating of the housing market.

Figure1: Effective Federal Funds Rate



Source: Board of Governors of the Federal Reserve System.

Note: Shaded areas indicate US recession as determined by the NBER.

On the side of the rest of the world, the expansionary monetary policy of US will inevitably worsen the imbalance of local economy. Lower interest rates stimulate the domestic consumption in the US and henceforth increase its demand for imports. As a result, in the past decade, export oriented countries see a rapid growth of trade surplus, most of them come out of their trades with US. In China, because of the inflexibility of foreign exchange management and the strict control on capital flows, the consequences are even more evident. In 2001, China came out with a trade surplus of 17.4 billion US dollars, only 1.5% of GDP. In 2007, China's trade surplus reached 371.8 billion US dollars, 11.5% of GDP, and the total surplus amounted to 445.3 billion US dollars, 13.7% of GDP (see table 1). Huge surplus accumulates pressures on China currency and encourage speculation on Renminbi's appreciation, hot money coming in and state foreign reserve is surging up (see table 2).

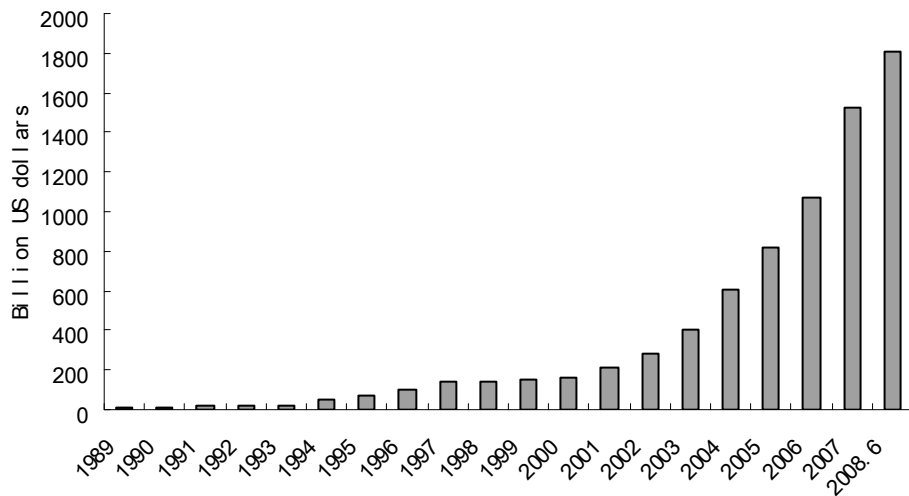
Table 1: China's Balance of Payment (2001-2007)

Billion US dollars

	Total	% of	Current	% of	Capital	% of
	Surplus	GDP	Account	GDP	Account	GDP
			Surplus		Surplus	
2001	52.2	4.5	17.4	1.5	34.8	3.0
2002	67.7	5.5	35.4	2.9	32.3	2.6
2003	98.6	7.0	45.9	3.3	52.7	3.7
2004	179.4	10.9	68.7	4.2	110.7	6.7
2005	223.8	10.1	160.8	7.2	63.0	2.8
2006	259.9	9.9	253.2	9.6	6.7	0.3
2007	445.3	13.7	371.8	11.5	73.5	2.3

Source: State Administration of Foreign Exchange website www.safe.gov.cn.

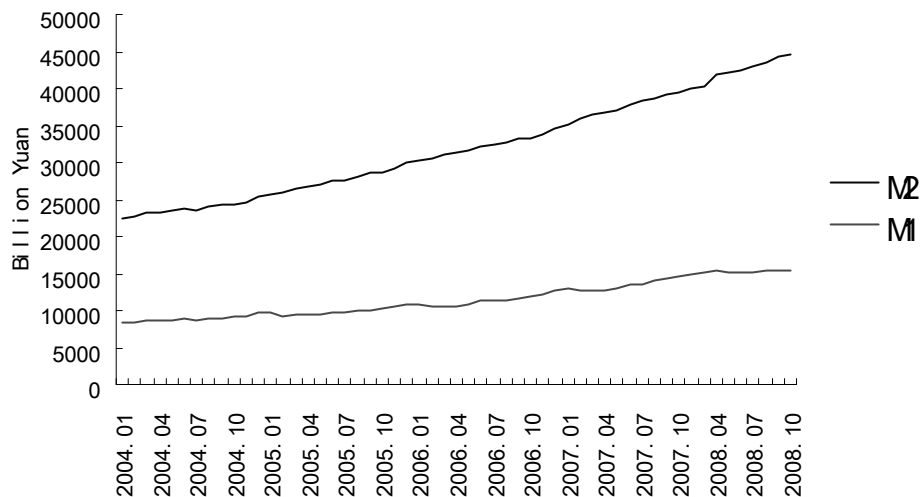
Figure 2: China's Foreign Reserves (1989—2008)



Source: State Administration of Foreign Exchange website www.safe.gov.cn.

As can be seen in figure 3, in spite of that China's central bank tries every effort to sterilize the additional money supply, money supply is growing at rapid pace. For the time being, the People's Bank of China, China's central bank, finds it is moving along the edges of the so called Krugman's Eternal Triangle: among the three good things, fixed exchange rate, capital control and independent monetary policy, only two of them are available. The outcome of the game is self-evident: PBOC meets a lot of difficulties in steering its monetary policy. Consequently, domestic inflation is gaining momentum and real interest rate becomes negative.

Figure 3: China's Money Supply (2004—2008)

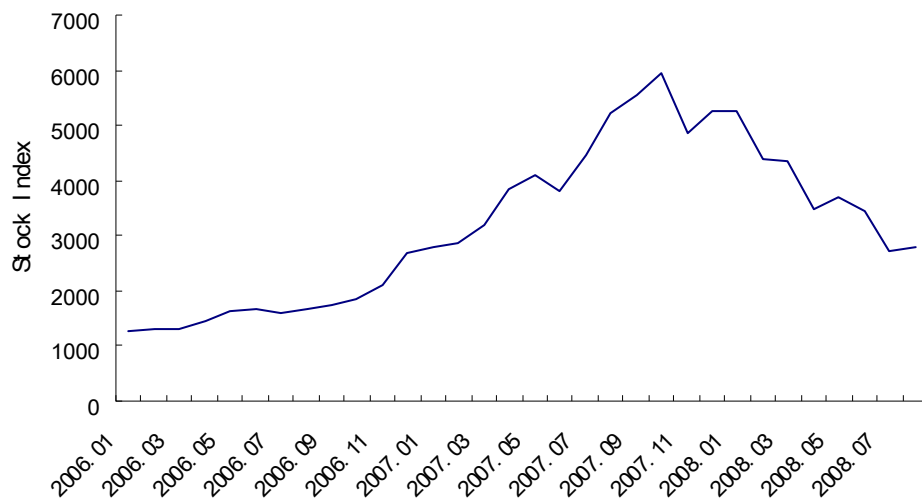


Source: People's Bank of China website www.pbc.gov.cn.

3. Resource misallocation and assets bubbles

From now on, there is nothing new to tell about China's story. History is repeating itself. Negative interest rates stimulate speculative investments into asset markets, stock market burns first and then housing market follows. The order of their bursts is also the same: first the stock market, and second the housing market. Figure 4 records the movement of Shanghai Composite Index. Almost overnight, two thirds of the cap value has been vaporized.

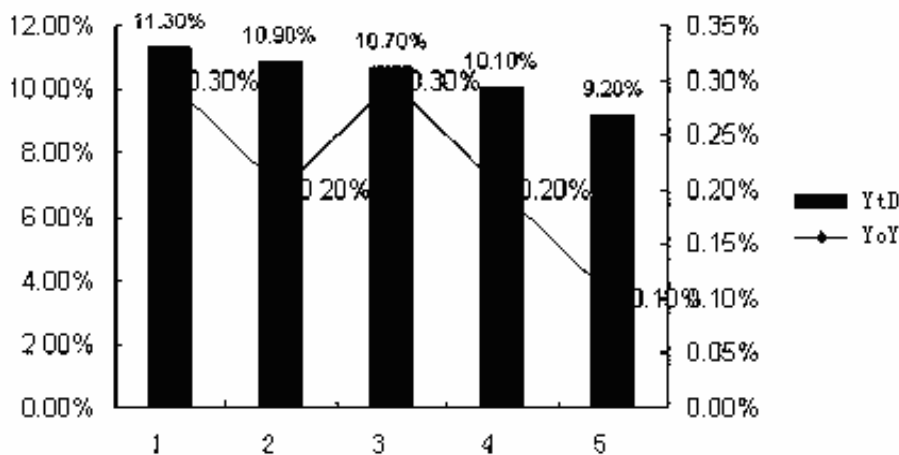
Figure 4: Shanghai Composite Index (2006-2008)



Source: China Securities Regulation Commission website www.csrc.gov.cn.

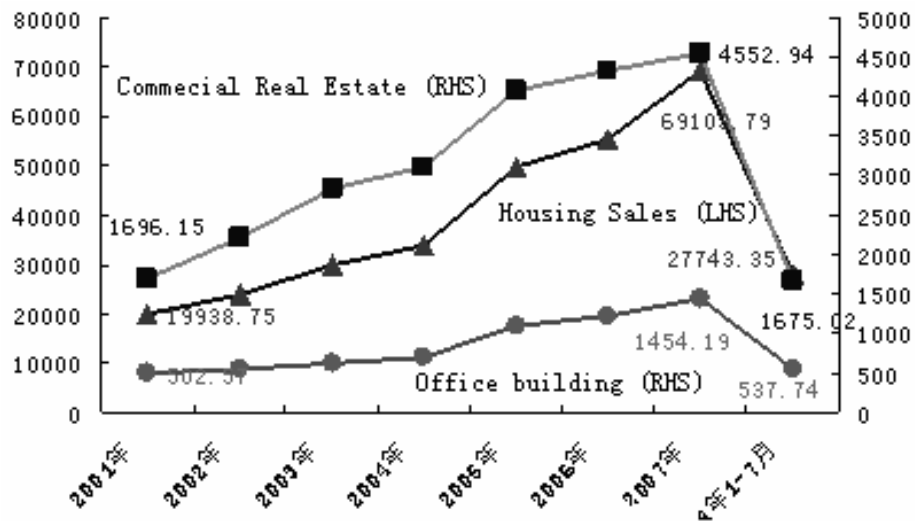
On the side of real estate market, Domino effect is emerging. Figure 5 shows the growth rates of overall real estate price in the first 5 months in China. It is very clear that the growth rate is falling down. Spontaneously, the sales volume is shrinking dramatically (see figure 6).

Figure 5: Housing Price Is Losing Momentum



Source: China Real Estate Association.

Figure 6: House Sales Decreased



Source: China Real Estate Association.

4. Risk Management Strategy

There is no doubt that the potential risks we are talking about are systemic risks. In order to deal with systemic risk, we can't always focus your attention on details, but rather, we need to see the whole picture and try to catch the rhythms of the market. In one word, we need to dance with all of the dancers.

The following strategies are being practiced by China banks:

- 1) Follow the advices of the government. When the boat is on the wave, it will be better to have just one person to steer the way. In China, the government will be the most qualified candidate. Sometimes, the window advices are pretty much helpful to commercial banks.
- 2) Limit or reduce exposures to vulnerable sectors. Frequent stress testing is required.
- 3) Switch to dynamic reserve policy.
- 4) Enforcement of Basel II proposal.

Are there any more recommendations? I'm looking forward to getting advices from our fellow bankers.