ECONOMIC VIEWPOINT

China's Financial System: More Vulnerable but Remains Resilient

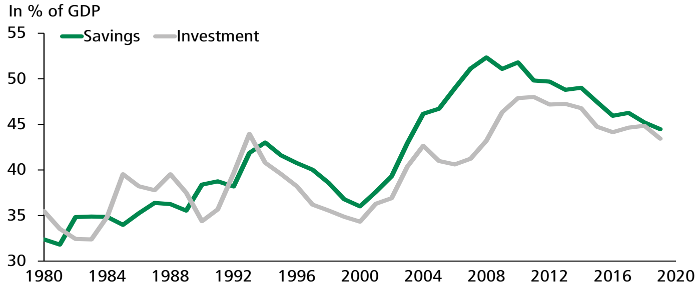
The faster-than-expected slowdown of China's economy in 2018 and 2019 has raised concerns about the health of the world's largest economy. While the slowdown was felt around the world, China received special attention due to its enormous weight in the global economy and its financial system, which is starting to show a few warning signs. Is this situation cause for concern for the rest of the global economy?

With the plan to transition China from an international manufacturing economy to a service economy driven by domestic consumption, the Chinese government had embarked on a path of gradual deceleration of the economy that has been visible for the last decade. However, the China–U.S. trade dispute and the gloomy economic situation in 2018 and 2019 led to a faster-than-expected slowdown of the Chinese economy. The latter's difficulties have also brought to light certain vulnerabilities that could cause greater instability in China and the rest of the world. China's financial system is a major risk factor as it is displaying considerable imbalances.

Current Account Reversal

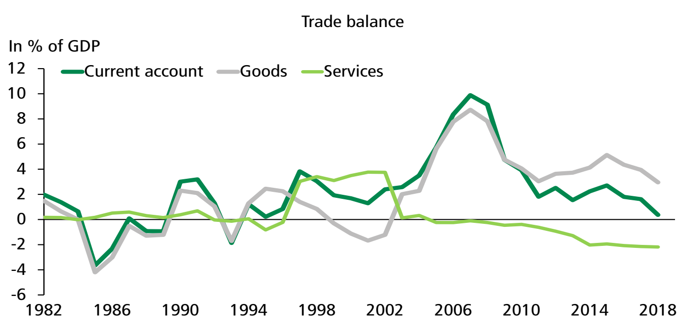
Since the 1980s, China's main growth vehicle has been investment. China's particularly high savings rate (graph 1) has helped finance massive investment projects enabling it to develop its manufacturing industry and the infrastructure needed for world trade without relying too heavily on foreign capital. This caused China's current account balance to post large surpluses for several years (graph 2). However, the general slowdown in international trade since the 2008–2009 crisis, China's aging population and the shift to an economy that is more focused on domestic consumption, and therefore less on savings, have reversed this trend. The savings rate has weakened and imports have grown faster than exports, giving way to a deterioration of the current account balance. The latter is expected to drop durably to negative territory soon. Although exports of goods appear to remain high, the trade balance for services is increasingly negative. Tourism is a major contributor to this deficit (graph 3 on page 2). As Chinese get wealthier, they tend to want to consume more luxury products and services, such as trips abroad. This trend reversal is not a problem at the moment, but a recurring trade deficit will gradually reduce China's financial independence, as it will need to attract more foreign capital to

GRAPH 1
A lower savings rate implies a greater reliance on foreign capital



Sources: International Monetary Fund and Desjardins, Economic Studies

GRAPH 2
Large current account surpluses have been wiped out



Sources: International Monetary Fund and Desjardins, Economic Studies

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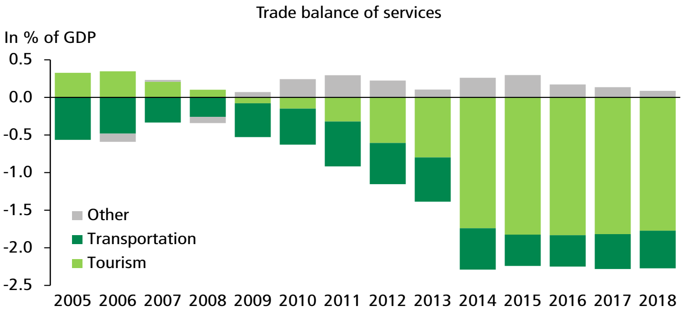
GRAPH 3
Tourism is the main cause of the trade deficit in services



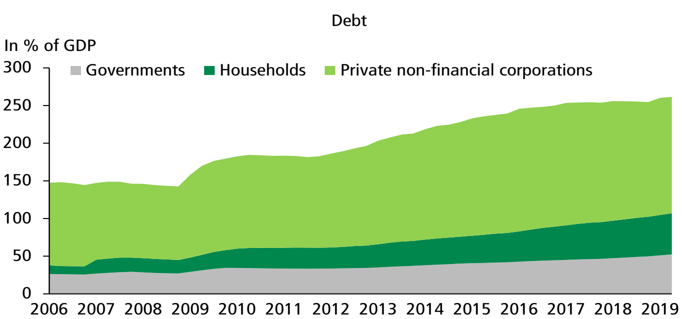
Sources: International Monetary Fund and Desjardins, Economic Studies

maintain a similar investment rate. Without a greater opening in capital flows, this could be difficult. However, China could also opt for a reduction in investments, especially those that may be less productive.

A Debt That's Taking a Toll

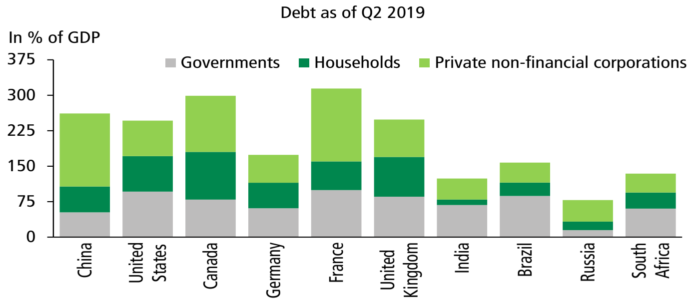
China's debt ratio has been trending up since 2009 and, excluding the financial sector, China's debt now sits at over 250% of GDP (graph 4). This high level of debt has also been seen among developed countries but is far less common in emerging countries (graph 5). An upward trend has been noted in all sectors, but private non-financial corporations have issued the majority of China's debt. Such a high level of debt leads to greater vulnerability to economic shocks, as the private sector's financial means are increasingly limited. In fact, a large portion of household and private non-financial corporations' income went towards debt servicing in 2018 (graph 6). Although the payment of interest on debt remains moderate in the economy overall, the burden falls heavily on the private sector. This limits the ability of businesses and households to borrow more, especially in the face of economic and financial shocks. More direct consequences of this high corporate indebtedness are beginning to surface, with the number of corporate defaults surging since 2018 (graph 7).

GRAPH 4
Debt in China continues its upward trend



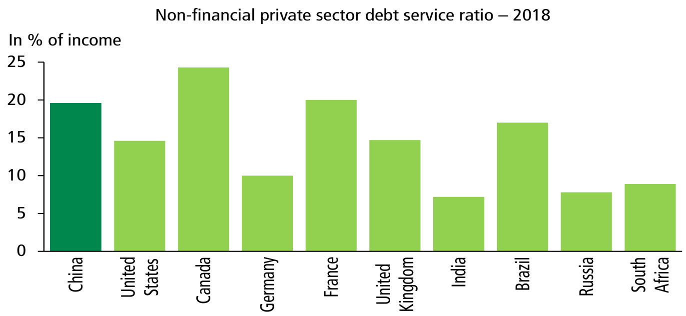
Sources: Bank for International Settlements and Desjardins, Economic Studies

GRAPH 5
China's debt is high compared to other BRICS countries



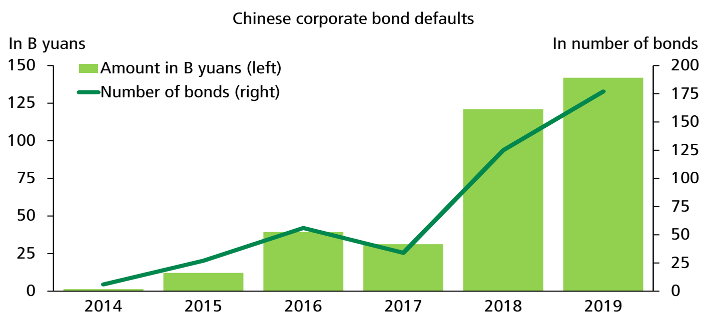
BRICS: Brazil, Russia, India, China, South Africa
Sources: Bank for International Settlements and Desjardins, Economic Studies

GRAPH 6
China's debt takes a toll on the private sector



Sources: Bank for International Settlements and Desjardins, Economic Studies

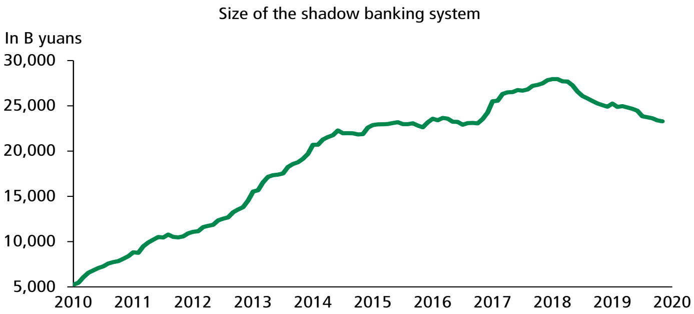
GRAPH 7
The number of corporate defaults has increased significantly over the past two years



Sources: Caixin and Desjardins, Economic Studies

The presence of a considerable shadow banking system has certainly fuelled the expansion of credit in China. Although the government's repressive measures against the sector since 2018 appear to have had an impact, loans issued by the shadow banking system, often associated with an elevated risk of financial instability, remain high (graph 8).

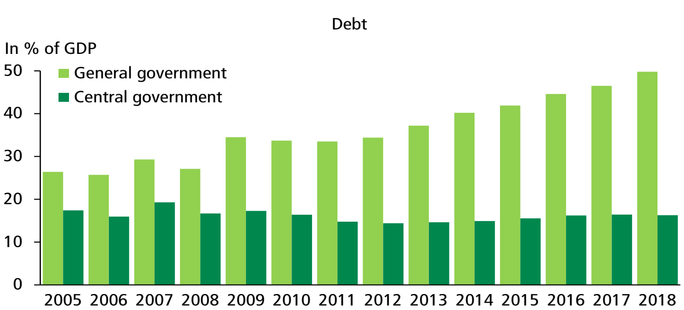
GRAPH 8
Measures to curb the shadow banking system appear to be effective, but its magnitude remains extensive



Sources: Bloomberg and Desjardins, Economic Studies

China's sovereign debt has also increased, reaching 50% of GDP in 2019. While this level is not particularly high when compared to other emerging countries, China's economic difficulties and the government's efforts to support the economy suggest that the picture is likely to deteriorate further. However, the central government's debt has remained relatively stable and low in relation to GDP, suggesting that it was local governments that contributed to the increase in debt (graph 9). Massive infrastructure investments by various provinces and municipalities have not yielded significant enough economic benefits to stabilize the debt ratio. Indeed, some of these investments have been used to build unused roads or empty cities, which has not led to productivity gains and has only served to temporarily inflate GDP. For now, the Chinese government still has sufficient resources to deal with negative economic shocks. However, further indebtedness by local authorities would increasingly limit their ability to finance infrastructure projects under expansionary measures and could even lead to defaults.

GRAPH 9
Rising sovereign debt is coming from local governments

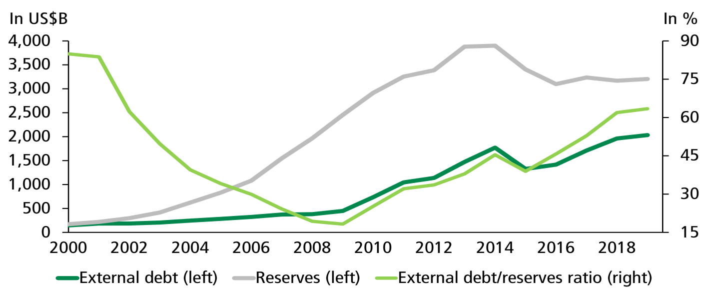


Sources: National Bureau of Statistics of China, Bank for International Settlements and Desjardins, Economic Studies

Integration into the Global Financial System Remains Limited

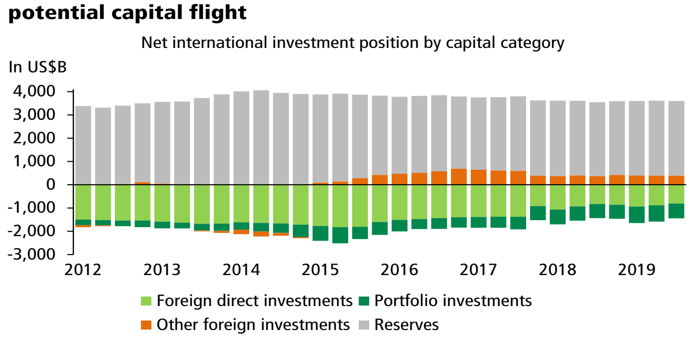
Despite its importance in the global economy, China is not yet very integrated into the international financial system. Its external debt has increased, but it remains low in terms of GDP or even its foreign asset reserves (graph 10). As a result, the vast majority of China's debt is still financed nationally. Moreover, even if large outflows of foreign capital were to occur, China's reserves would still be more than sufficient to offset them (graph 11). Foreign direct investments currently account for more than half of China's stock of foreign capital. These are normally considered less prone to sudden disinvestments given the high cost of moving them. However, the liberalization of capital flows introduced in recent years has increased Chinese investments outside the country, with China now holding nearly as much

GRAPH 10
Despite the rise in China's external debt, it remains moderate relative to reserves



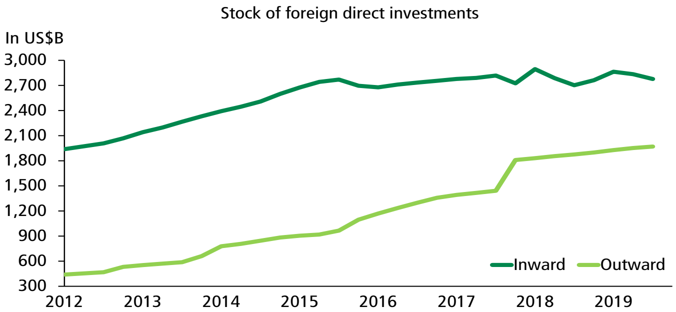
NOTE: Data for 2019 ends in the third quarter.
Sources: World Bank, State Administration of Foreign Exchange and Desjardins, Economic Studies

GRAPH 11
China's foreign asset reserves are more than enough to cover a potential capital flight



Sources: State Administration of Foreign Exchange and Desjardins, Economic Studies direct investments abroad as those held by foreign investors in China (graph 12). China could reverse some liberalization measures to prevent capital from leaving the country, thereby meeting local financing needs.

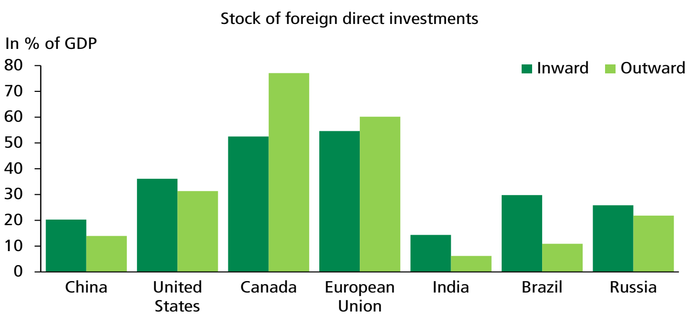
GRAPH 12
Chinese are investing more and more abroad



Sources: State Administration of Foreign Exchange and Desjardins, Economic Studies

However, one aspect we should keep an eye on is the quality of Chinese capital in other countries, especially among emerging economies in sub-Saharan Africa and Latin America. Some of the countries that have received Chinese capital have very high debt levels and an unstable political and economic situation. Although the value of its foreign direct investments remains relatively moderate relative to the size of the Chinese economy (graph 13), China is now slightly more vulnerable to foreign financial shocks.

GRAPH 13
Foreign direct investments remain generally low relative to China's GDP



Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

Conclusion

China's financial system still appears resilient as the country has large reserves and its debt is mainly financed by national savings. Despite the liberalization of capital flows, its market remains relatively closed. Steps have recently been taken with the signing of the trade agreement between China and the United States to open up part of the Chinese banking system to U.S. institutions. The effect of this opening remains to be seen. All in all, it seems that the financial system in China is becoming increasingly vulnerable to a potential shock, and without serious reforms to fix its debt and banking system, the risk of a financial crisis could increase over the next decade. In the shorter term, China's ties to the global financial system are still limited, and the effects of a financial shock in China would be felt mainly domestically. Outside the country, we could see more serious adjustments to the demand for commodities and their global prices. Producers of these commodities, such as Canada, could also be adversely affected.

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