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Economics Group

Special Commentary

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Is China the Next Bubble?

Expansionary Policies Have Helped to Boost Growth

Recently released data showed that the year-over-year growth rate of Chinese real GDP rose from 6.1 percent in the first quarter of this year to 7.9 percent in the second quarter (Figure 1). Monthly data certainly suggested that economic growth in China was picking up steam in the second quarter, so the confirmation that overall GDP accelerated in the recently completed quarter was a pleasant, albeit not totally unexpected, outturn.

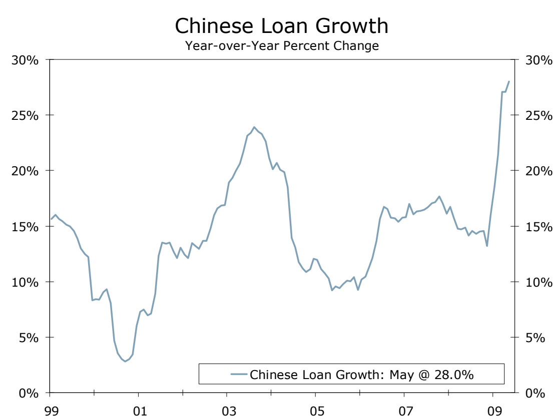
Why is the Chinese economy accelerating again? A breakdown of real GDP into its underlying demand components is not available, but monthly data offer some clues. First, foreign trade is starting to stabilize. The swoon in exports in the second half of 2008 and early this year exerted a powerful drag on the Chinese economy. Now that foreign trade is starting to stabilize, Chinese real GDP growth is returning to its underlying "run rate." In addition, growth rates of retail spending and investment spending have also strengthened over the past few months.

Strength in domestic spending reflects the effects of policy stimulus.

So why are Chinese consumers and Chinese businesses opening up their wallets with newfound vigor? The Chinese government responded very quickly and aggressively to the global financial crisis last year, and the recent acceleration in domestic spending reflects, at least in part, the effects of policy stimulus. The government implemented some modest tax cuts late last year, which may help to explain the acceleration in consumer spending, and its sizable infrastructure spending program is helping to boost investment spending.

Figure 1

Figure 2



Source: CEIC and Wells Fargo Securities, LLC

Monetary policy was also eased via a number of channels. Not only did the central bank cut its benchmark lending rate by more than 200 bps between September and December but, more importantly, the government rescinded lending restrictions that were put in place in early 2008 when inflation was seen as Public Enemy #1. Indeed, the government has been actively encouraging banks to lend, and its efforts appear to be paying off. As shown in Figure 2, loan growth has simply exploded over the past few months. The current rate of lending growth exceeds the super-charged rates that were registered earlier this decade when the government was attempting to stimulate the economy at that time.

Should we be worried about the strong rate of lending growth in China at present? In its zeal to jumpstart the economy, is the Chinese government sowing the seeds of yet another bubble that will have disastrous consequences for not only China but for the entire global economy?

The Chinese Economy is Not Overly Leveraged at Present

The Chinese banking system has plenty of deposits to support strong growth in lending.

Figure 3 offers some perspective on recent loan growth in China and the state of that country's banking system. Yes, loan growth has been robust over the past few months. However, there is no shortage of deposits to lend in China. Indeed, the loan-to-deposit ratio of the Chinese banking system has trended lower over the past decade or so, and it is well below the comparable ratio for the United States. Not only are Chinese households consummate savers, but the relative immaturity of the country's capital markets forces most individuals to hold the bulk of their liquid wealth in the form of bank deposits. In addition, the profitability of the business sector over the past few years has allowed Chinese companies to increase their deposits as well. Moreover, the nonperforming loan (NPL) ratio in the commercial banking system is only 2 percent at present, the lowest ratio in years.

Figure 3

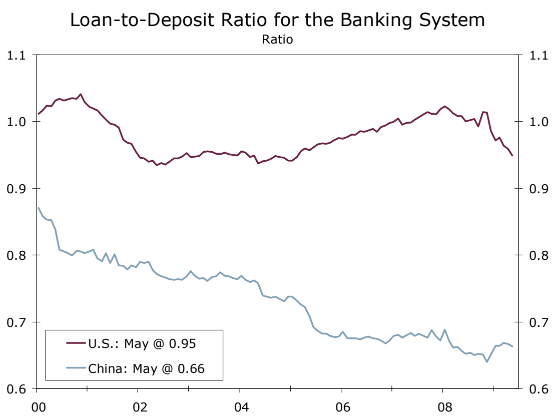
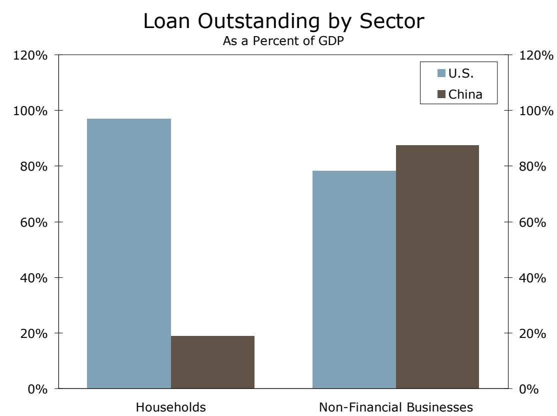


Figure 4



Source: CEIC and Wells Fargo Securities, LLC

Just because the Chinese banking system has a low NPL ratio and is flush with liquidity does not mean it is making sound loans at present. Indeed, the very abundance of excess liquidity raises concerns that banks may now be making ill-advised loans. Although we have no way of determining the soundness of new Chinese loans at present, we can analyze whether important sectors of the Chinese economy are overleveraged. Excessive amounts of leverage now could spell troubles down the road.

The indebtedness of the Chinese household sector is rather low.

Figure 4 shows a measure of indebtedness for the household and nonfinancial business sectors in China. Loans to consumers are equivalent to less than 20 percent of Chinese GDP, well below the 97 percent ratio found in the United States at present. As noted earlier, Chinese capital markets are relatively immature and the relative difficulty that Chinese residents have in securing a mortgage and other forms of credit, at least by the standards of their American counterparts, has helped to keep the indebtedness of the Chinese household sector rather low. Even with lax lending standards at present, it doesn't seem likely that the Chinese household sector is on the verge of "blowing up."

Relative to households, the loan-to-GDP ratio for the nonfinancial business sector in China is rather high at present, but it is not wildly out of line with the comparable ratio in the

United States (Figure 4). Moreover, the ratio in China has trended down from 100 percent in 2004 to 87 percent at present. Among industrial firms, interest expense has declined from nearly 3 percent of revenue in 2000 to about 1 percent at present, and the liability-to-asset ratio has dropped from about 0.62 to 0.58 over that period. If the current financial position among industrial firms is reflective of the overall business sector, then a rash of bankruptcies does not seem to be in the cards, at least not in the near term.

Figure 5

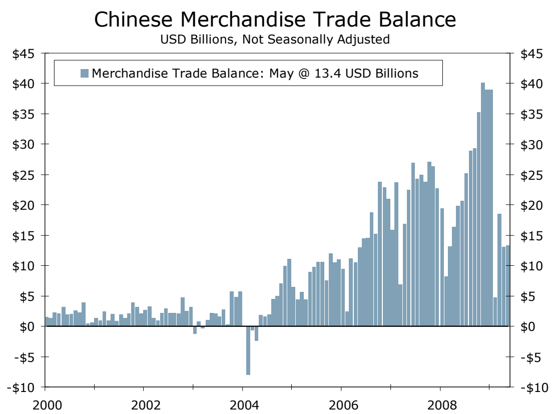
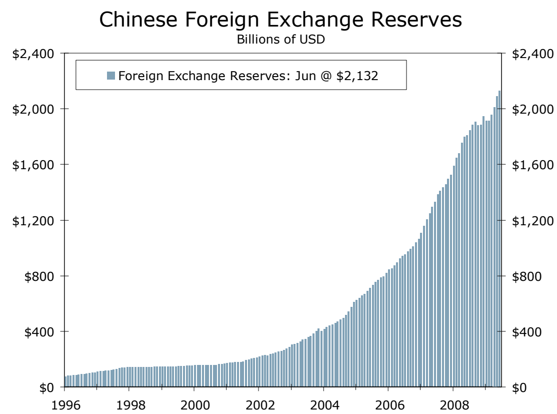


Figure 6



Source: CEIC and Wells Fargo Securities, LLC

Looking at individual sectors, we have found few signs of excessive leverage in the Chinese economy. This conclusion is consistent with the analysis from a top-down perspective. China posted a current account surplus last year that exceeded $400 billion, nearly 10 percent of nominal GDP. A country runs a current account surplus when production exceeds spending. In other words, a country with a current account surplus is a net lender to the rest of the world, not a net borrower. At the height of the housing bubble in 2006, the United States incurred a current account deficit of nearly $800 billion (about 6 percent of GDP). This large U.S. current account deficit was *prima facie* evidence that the country was in dangerous financial waters.

Although China currently has less black ink in its merchandise trade account than it did last year, China should post another large current account surplus (Figure 5). The string of massive current account surpluses over the past few years has caused the country's foreign exchange reserves to swell to unprecedented heights (Figure 6). China used about $45 billion of its foreign exchange reserves earlier this decade to recapitalize two of its four state-owned commercial banks. The country's foreign exchange reserves have subsequently risen from $400 billion at the end of 2003 to more than $2 trillion at present, giving it ample financial resources to recapitalize the banking system again, should that prove necessary. Given that the NPL ratio in the commercial banking system is only 2 percent at present, recapitalization does not seem necessary anytime soon.

The country has ample financial resources to recapitalize the banking system again, should that prove necessary.

Conclusion

China had a lending boom in the 1980s that eventually went bad, and real GDP growth, which has averaged nearly 10 percent per annum since 1980, slowed to only 4 percent in 1989 and 1990. Remembering that painful episode, the Chinese government was determined not to make the same mistake when the combination of the Asian economic crisis and global recession caused Chinese growth to slow about a decade ago. Although loan growth was very strong in 2003, the government clamped down on lending in 2004 when the Chinese economy began to accelerate. A lending bubble was averted, and the Chinese economy did not overheat like it did in the late 1980s. Given its success in engineering a "soft landing" in the last cycle, the government may feel confident that it can clamp down again when the appropriate time comes.

However, determining when the appropriate time has arrived could prove difficult. Global growth probably will be sluggish over the next year or two, and the Chinese government could keep the lending taps open to ensure that real GDP growth in China remains supported. If credit growth remains robust for an extended period of time, a number of ill-advised loans surely will be made. These loans could eventually come back to haunt the Chinese government.

We titled this report "Is China the Next Bubble?" Well, is it? If it is, we probably are in its very early stages. Despite the sharp increase in lending over the past few months, there is little evidence to support the notion that important sectors of the Chinese economy have excessive amounts of leverage at present. Obviously, specific households and individual businesses may have borrowed too much recently, and they could run into problems. However, leverage does not seem to be a systemic problem at present. If we had to list five things that keep us lying awake at night, worries about the imminent bursting of a credit-fueled bubble in China would not be on that list. That said, if Chinese credit growth remains unabated over the next few years, our nights may eventually become more restless.

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