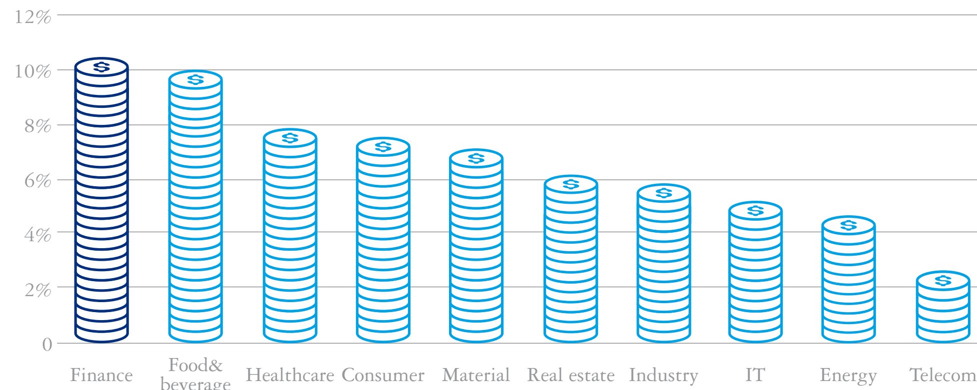
Given a high GDP growth target, policymakers might push the panic button and turn on the liquidity tap in order to forestall an economic downturn - this would be unfortunate but not inconceivable.

Can the Punch Bowl Really Be Taken Away?

BY / Sitao Xu

While Chinese policymakers concur on the need for deleveraging, what to tackle first remains a much debated issue. At present, the trend seems to favor financial institution reform. For example, regulators recently put the issuance of online micro-lending licences on hold; earlier, they banned ICOs (initial coin offering). Indeed, it could well be that policymakers have decided to start with the financial sector because in this sector irregularities are pervasive and profits are widely seen as being "excessive". Even some of the most successful Chinese entrepreneurs have complained that "they are laboring only to service bank loans". Therefore, a reduction of the financial sector's leverage seems both sound economics and good politics.

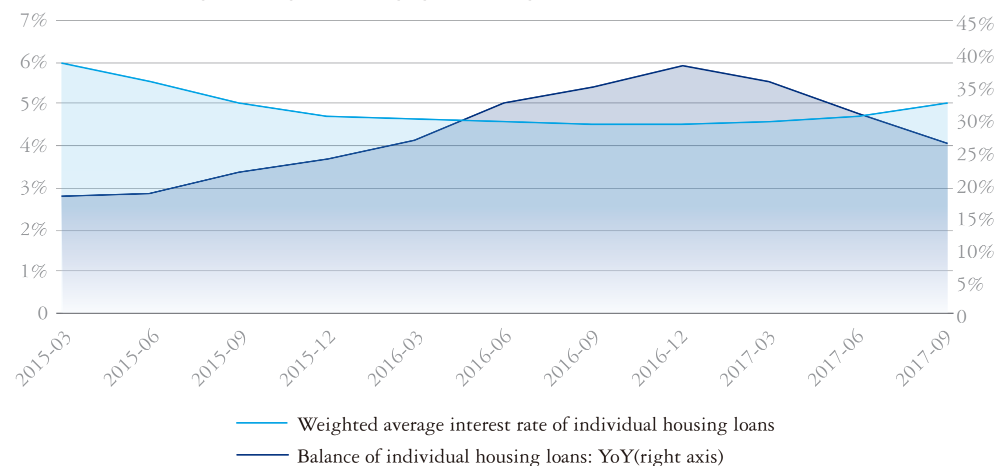
Chart 1: ROEs excluding extraordinary gains or losses in 1-3Q17



Source: Wind, Deloitte Research.

But, tighter control of the banking sector means that banks will be forced to rein in activities which are not included in their balance sheets and therefore interest rates will have to go up. Actually, recent data shows that the interest rates have already begun to rise. For example, banks in several major cities started to hike mortgage rates to 15% above benchmark rates in summer and, by late November of 2017, 10-year treasury yields have exceeded 4%. Such spikes of interest rates are, in general, a reflection of stress in the financial system along with expectations of further monetary tightening precipitated by the Fed. Higher interest rates are likely to weigh on future investment and property market.

Chart 2: More tightening in mortgage lending



Source: Wind, Deloitte Research.

Slowing credit growth is the acid test of policymakers' commitment to deleveraging (a commitment that will remain firm as long as the economic growth rate holds up). Barring any major external shocks (e.g., geopolitical risks and trade protectionism), we expect policymakers to stay on course, deflating all "bubbles" gently. However, if the housing market experiences a major downturn (for example, a greater than 20% drop in housing prices), authorities might push the panic button and turn on the liquidity tap in order to forestall a more generalized economic downturn. This, of course would be highly unfortunate but not inconceivable given the kind of pressure policymakers come under. A high GDP growth target would increase the odds of just such a knee-jerk policy reaction. We all know that credit booms most often end in a bust. On the other hand, which government has ever dared to "take the punch bowl away when the party is getting good"?

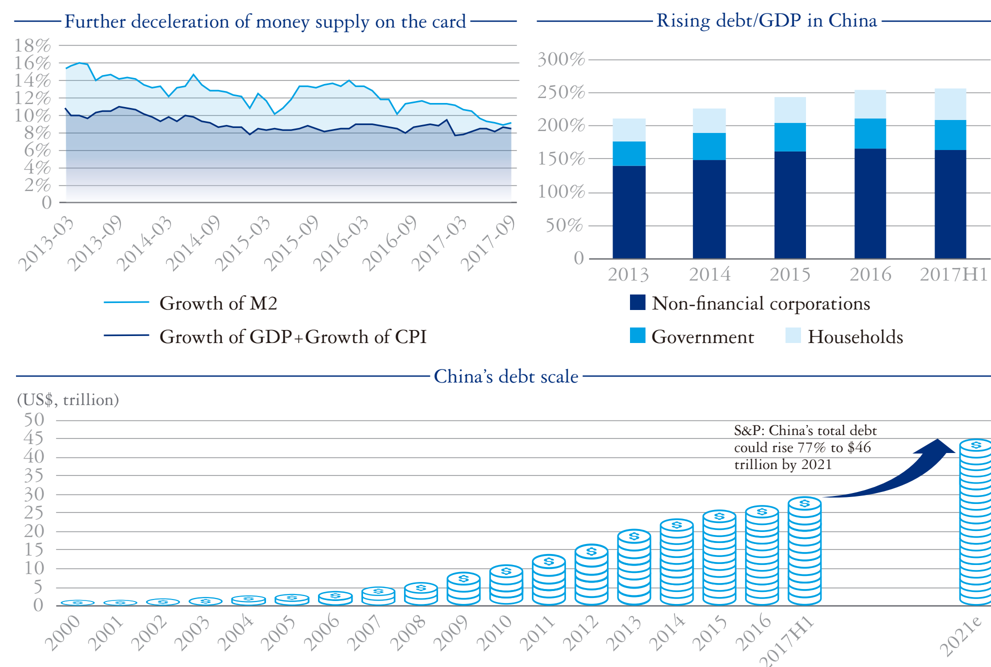
But if history is to be any kind of guide, financial crises in emerging markets tend to cause far greater social dislocation than those in developed markets. The Asian Financial Crisis, which started with a forced devaluation of the Thai Baht in July 1997, is a case in point. Not only did Thailand's currency troubles spread like wildfire to neighboring states like the Philippines, Malaysia, Indonesia and Korea, but also the sheer magnitude of the destruction of value in terms of stock prices, property valuation, exchange rates etc., and its effect on the real economy far exceeded most economist's predictions. That was why Zhou Xiaochuan, central bank governor, alluded to the risk of a Minsky moment in China (economic risks which are associated with a sudden drop in asset prices), during the 19th Party Congress. But, the best way of avoiding a Minsky moment is continued financial reform.

The speculative attacks against Asian currencies twenty years ago fundamentally changed the psyche of most Asian policymakers. As a result, many of them have adopted so-called clean float policies (flexible exchange rate with some interventions) but the bias for intervention has been to set the currencies at competitive levels. Today, none of the Asian economies which has suffered during the crisis has an over-valued currency. On the contrary, most Asian economies have a comfortable balance of payments. At the same time, emerging Asia is significantly relying on China to be a key economic player in the region, providing liquidity support and funding to neighboring economies.

From this perspective, the surprising announcement from China's Ministry of Finance raising the ceiling on foreign ownership in banking, se-

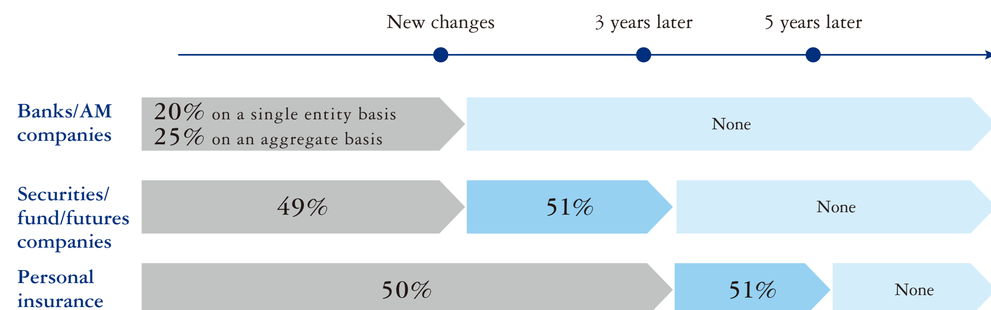
curities and insurance sectors on the heels of U.S. President Donald Trump's visit to China is encouraging as the entry of foreign financial institutions will create more competition in the sector and reduce political interference, which will, in turn, improve resource allocation. Yet, this important move towards financial liberalization has been criticized by some foreign China-watchers who suspect that such liberalization is aimed at recapitalizing unsound domestic financial institutions with foreign capital. I find this argument hard to believe: first, because one of the lessons garnered from the Asian Financial Crisis is that foreign-led bailouts always come with the conditionality of austerity programs. Moreover, China does not really need foreign capital and this liberalization is more about keeping credit growth under control and giving credibility to its liberalization drive than getting foreign money to recapitalize failing companies.

Chart 3: Policymakers are aware of "Minsky Moment"



Source: Wind, BIS, S&P, Deloitte Research.

Chart 4: Roadmap of China's opening on foreign ownership limit



Source: public information, Deloitte Research.

Over the past two decades, there has been no shortage of analyses of the Asian Financial Crisis. What are the key lessons that should have been drawn by policymakers, especially in the context of the rise of China? If China were hit by a financial crisis today, would the contagion effect be greater than that of the Asian Financial Crisis? Or perhaps a more pertinent question would be: what lessons can Chinese policymakers draw from the Asian Financial Crisis to avoid having something similar occur in China?

There are three major lessons to be learnt from the Asian Financial Crisis. In essence, the crisis was triggered by a lending boom fueled by hot money and underpinned by fixed exchange rates. The sharp appreciation of the USD exposed the vulnerability of fixed exchange rates and corporate profit squeezes prompted sudden capital outflows. One could also argue that the IMF bailout packages were perceived by crisis-hit countries as hugely favoring creditors, which exacerbated social tensions. Given this, we believe that first of all, emerging economies, unlike developed countries (with mature and deep capital markets), should not liberalize their financial sectors too quickly. A corollary of this is that, even if financial liberalization is gradual, the sequence of deregulation matters. Second, it is dangerous to have a prolonged period of exchange rate misalignment. This is particularly true if the economy is overheating as was the case in Thailand, Korea and Indonesia in 1996. Third, it is important not to mix up sovereign risk with corporate risk. "Too big to fail" has proven to be fatal to many of the economies (Korea particularly) suffered during the crisis. In Korea for example, the chaebols, or conglomerates were venturing into many businesses with little regard to financial discipline. As a result, the costly bailout of chaebols (which were considered to be "too big to fail") by the government was disapproved by the market (as the contingent liabilities of the chaebols were far greater than Korea's foreign reserves) causing a further run on the Korean won.

These three lessons have been taken to heart by most Asian economies. Fixed exchange rates were largely abandoned in emerging Asia since the outbreak of the crisis. In fact, exchange rates in most emerging economies have been at a relatively under-valued level, resulting in a healthy level of foreign reserves. From China's perspective, to overcome the "fear of float" will be no small feat given the distress of the initial de-peg from the USD in 2005 and the mild devaluation in August 2015. Despite the jitters that followed, the policy of shifting from a fixed exchange rate to a more flexible one has remained intact. So even though the RMB has been under persistent downward pressure for nearly a year and a half, there has been no change in policy and as a result, market sentiment changed for the better in 2017 (actually up by nearly 6% against the dollar).

The present PBOC game plan is a combination of targeting a basket of currencies and policy discretion. Meanwhile, the PBOC deliberately keeps sizeable foreign reserves in excess of import needs and external debt servicing. Such a war-chest provides the necessary confidence to domestic savers and as long as the war-chest remains, irrespective of slight fluctuations, their confidence in the domestic banking system is unlikely to waver. However, Chinese savers' entrenched faith in their domestic financial system has also created a certain kind of "moral hazard". The latter boils down to the belief that the Chinese Government will bail out all finan-

cial institutions at any cost. The fact that long term government bonds (China's sovereign risk) are yielding rates which are on par with money market rates precisely underscores our point. The best way to mitigate moral hazard is to let some insolvent financial institutions fail. But to engineer "directional blasting", or to keep failures within a confined environment, requires some relaxation of the doctrine of maintaining stability at any cost.

Chart 5: Vanishing risk premium

Source: Wind, Deloitte Research.

This is all the more important as, unlike most Asian economies prior to 1997, financial liberalization in China has been rather slow and extremely cautious. For example, the Chinese Government created the Bond Connect between the mainland and Hong Kong, but only allows one-way flows into the Chinese bond market. The stock market, the 2nd largest in the world based on market capitalization, is only open to foreign investors through schemes of QFII (Qualified Foreign Institutional Investors) and the Shanghai-Hong Kong Stock Connect. In addition, the fact that China has preferred to first liberalize the bond market where foreign participation is more long term and less fickle shows that the government would like to avoid big swings of portfolio flows. And even on the much touted RMB internationalization, policymakers have reoriented their efforts towards greater use of the currency in international trade and its use as a funding vehicle for Belt and Road Initiative rather than pushing for full internationalization. This is because the strength of the RMB has become a pre-condition for further internationalization of the currency, at least for policymakers.

Looking ahead, financial liberalization is likely to continue to be gradual in China. Hence, control of capital account transactions (e.g., residents' purchases of overseas securities and real estate are not allowed) may stay in place for longer than previously anticipated. Is capital control the right policy during a financial crisis? One country that took that route in late 1998 was Malaysia which decided to fix the ringgit at 3.80 to the dollar while the market price was 4.20. The decision was controversial but was later vindicated when Asian economies started on the road to recovery in 2000. The reasoning behind Malaysia's unorthodox implementation of capital controls was that it would prevent a free fall of the market; and that the market has a short memory. One should also not forget the timing: for Malaysia's capital controls came into effect at the tail-end of the Asian financial crisis which means most Asian markets were unlikely to invite further attacks from speculators given distressed asset valuation. The moral of the story is that while capital controls are by no means a panacea, the timing of imposing capital controls for Malaysia was good as they only did it when the worst of the crisis had passed. From this perspective, China's measures of strict capital controls earlier this year operated against a backdrop of a weakening USD. The weakening dollar also partially explains the recent eleven consecutive months of rise in foreign reserves in China. Forcing the financial sector to lower leverage indicates that policymakers are taking potential financial sector risks very seriously. The one-way Bond Connect has sent a clear signal that the policy framework will continue to address "reckless" overseas investment. The PBOC's efforts at replenishing reserves and holding them at more than necessary levels have underscored its commitment to maintaining a credible war-chest.

In the short run, some obstacles are likely to emerge. What if the dollar starts rallying on the back of let us say, geopolitical tensions or tax reform in the US? Will the PBOC continue to buck the trend? Will rising interest rates cause the housing market to weaken significantly? In past year, the PBOC has made RMB exchange rate stability as the overarching goal, which inevitably has raised the issue whether some flexibility would have to be restored in 2018. Can the PBOC resist the pressure of loosening the liquidity tap should interest rates be pushed up more than policymakers foresee?

In our view, lowering the GDP growth target after the 19th Party Congress will make it easier for policymakers to take away the punch bowl without the risk of a backlash. The emphasis of quality of economic growth at the Central Economic Work conference is an encouraging sign. Foreign reserves too do not need to be so high. In the medium term, to maintain excessive amounts of reserves is counter-productive, because it requires either a persistently under-valued RMB (not feasible before a meaningful revaluation) or strict capital controls, or both. The real question remains whether the core of supply-side reform, i.e. SOE reform, can regain traction. A breakthrough in SOE reform will bring down corporate leverage and spur private investment. As a result, the credit policy will be more conducive to a stable RMB, which will further reduce the need to accumulate reserves. Finally, on the political front, the risk of China resorting to retaliation if the Trump Administration up the ante on the trade front should not be discounted, following President Trump's labeling China as a competitor rather than a partner. In conclusion, to resist the temptation of stimulus packages, to dispel the notion of "too big to fail" and to meaningfully introduce foreign competition in the financial sector are the most important lessons for China today from the Asian Financial Crisis.

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