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The pressure on financial markets from China will abate

Uncertainty and worries about China have depressed financial markets

Alongside ongoing fears of a major recession, financial markets are being buffeted by a number of other concerns. These include the upcoming UK referendum on Brexit, divisions within the EU as to how to respond to the migration crisis, the low oil price and, not least, worries about China. Regarding the latter, investors seem particularly troubled by concerns about an imminent Chinese credit crisis, heavy outflows of capital and a further depreciation of the yuan.

Any credit crisis in China will impact the public sector banks and will be financed by the government.

Estimates about the extent of Chinese indebtedness vary but a figure between 230% and 240% of Chinese GDP seems realistic to us. Although such a level of indebtedness is below that of most industrialized countries, it is very high in comparison with other emerging growth economies. Perhaps more troubling than the extent of China's indebtedness is its rapid growth over the last 10 years. At around 80%, this is a faster growth rate than almost anywhere. In the past, very rapid credit growth in emerging growth economies has always been the precursor to a credit crisis. Although such credit crises started on average some 4 years after credit began to grow excessively, a credit crisis in the immediate future does not look likely in China. Firstly, the average borrowing interest rate has fallen since the beginning of 2014 from over 7% to around 5%, thus reducing debt burdens by around a quarter. Secondly, the authorities have started to refinance the debts of provincial governments through the issue of municipal bonds. Moreover, credit extended in external currencies – the traditional problem behind credit crises in emerging growth economies – has been falling for around a year and now only amounts to some USD 1'500bn. Should China's credit boom develop into a credit crisis, this is likely to be reflected in a rise in corporate bankruptcies. The resulting balance sheet impact would mainly be felt by banks in the public sector and, as happened towards the end of the 1990s, these would be rescued, or financed, by the government. Thus, even the write off of a quarter of the entire debts of the corporate sector need not cause a credit crisis in the classical sense because the government would step in. The effect on the government balance sheet would be an increase in indebtedness from 55% of GDP currently to a still manageable 90% of GDP.

Capital outflows from China should not be confused with capital flight.

In 2015 China had a net capital deficit of around USD 650bn. Given that the positive balance on the current account is nearly USD 300bn. implies, that there was a net capital outflow of almost USD 1000bn. last year. But a closer look suggests a less troubling picture. In fact over the last 10 years China has exported capital at roughly half the rate of last year's outflow in order to fund investments overseas. The big change in dynamic regarding

China's external balances in 2015 relates to external portfolio trends with foreigners holding less yuan. Researchers at Capital Economics and the Bank of International Settlements suggest the main factor here was the decision by Chinese companies to sharply reduce the scale of their overseas debts. Right now these external debts still total around USD 1500bn. We note that China's forex reserves are substantial (USD 3'200bn.) and would therefore be enough to prevent strong downward pressure on the yuan even in the unlikely event that these external debts were repaid in full. The recent decision of China's central bank to adopt a more stimulative monetary policy stance suggests it is not particularly concerned about capital export trends. Certainly, these point to a continuing net outflow. However, we believe this will be an orderly process with outflows diminishing over time.

Evidence suggests that the Chinese government is not interested in depreciating the yuan.
When the Chinese central bank decided on August 11 2015 to bring down the value of the yuan many investors interpreted the move as an economic decision to support China's export industries. At the time there was much chatter about "currency wars" and "competitive devaluation". Additionally, there were fears that a more lowly-valued yuan could strengthen already existing deflationary pressures on Western economies. When last December the People's Bank of China published an index for the yuan, these fears were revived as the move was seen as signaling a decision to downgrade the US dollar as an influence on the targeted value of the yuan. Closer inspection suggests fears that the Chinese are in fact targeting a weaker yuan are probably exaggerated. Since the start of last year the yuan has depreciated against the US dollar by just 5.5%. On a trade-weighted basis the yuan has been stable over this time. This result undoubtedly reflects the willingness of the Chinese authorities to intervene in size on occasion to support the currency. Such support amounted to over USD100bn. last December alone. Moreover, the Chinese government has adopted measures to strengthen capital controls as well as to boost capital inflows. With a current account surplus amounting to some 3% of her GDP, China has no obvious need for a weaker currency. All these points suggest that the Chinese authorities are not bent on weakening the yuan. Rather, it is our view that China would like to see a relatively stable yuan on a trade-weighted basis. With forex reserves of some USD 3'200bn, the authorities have enough ammunition for the foreseeable future to secure such a result.

The pressure on financial markets from China will abate.
Our analysis of Chinese economic and capital market trends suggests that current investor fears about China are excessive. In time, concerns about credit trends, capital flight and a depreciating currency will abate as will fears of a Chinese economic collapse.
In coming months China is set to become a less negative factor so far as the financial markets are concerned.