China’s Liquidity Crunch

At the height of China’s interbank liquidity crunch this past week Michael Pettis wrote a sensible commentary (http://globaleconomicanalysis.blogspot.co.uk/2013/06/michael-pettis-on-china-liquidity.html) that raised some good questions on the possible consequences of tighter credit conditions in the world’s second largest economy. With the help of some hindsight from recent days, we now know that the People’s Bank of China (PBOC) was forced to shift gears from its early stern directive that banks should manage their liquidity issues to a stopgap policy of providing extra liquidity at quarter-end presumably to facilitate the rollover of a large amount of Wealth Management Products (WMP) that were the the catalyst for the mini-credit crunch. Moreover, these sketchy structured products also are the principal financing vehicle of the shadow banking system that has promulgated a huge glut of loans this year despite China’s growing excess productive capacity amidst slowing global demand. No wonder that the central bank finally had to step up before it lost control of credit completely.

We can expect repeated recurrences of this episode for the basic reason that Pettis states so well:
"***One way or another we do have to write down the huge hidden losses in the country's balance sheet...***",
referring to the mismatch between the total value of Wealth Management Products outstanding, which some observers estimate at 60% of China's GDP, and value of the underlying assets, most of which are real estate ventures in various stages of development - or more precisely the mismatch between the short-term interest promised by the WMP and the cash flow generated by the underlying assets. Pettis concludes that the banking system in concert with the PBOC can manage the inevitable write-down of these losses over time in much the same way that Japanese banks worked with the BOJ to cleanse their balance sheets of a mountain of zombie loans to construction companies from 1996 to 2006. As a result, Japan's bottom line was almost two decades of little growth and deflation. While the PBOC might prefer the 'workout' solution, I doubt that Party officials and the Chinese public would tolerate those economic consequences for so long. This episode may not be China's 'Lehman' moment, but I suspect that one will occur sometime in the next few years. It is very difficult to figure out 'when' and what the specific catalyst might be. The place to look for trouble brewing is among those banks that are rumored to be offering 6% interest on the rollover of WMP. Like the American S&Ls in the late 1980s and Lehman in the 2000s, the most vulnerable banks are the ones that double up when they should be winding down sketchy products.

Interestingly, I had lunch yesterday with the former chief economist of Lehman's at the time of its demise. He recounted stories of the run-up to the bank's collapse. Lehman was one of the biggest issuers of mortgage-backed securities and were engaged in

subprime structures. Some observers, including myself, believe that the eventual 'catalyst' for Lehman was the defaults by Fannie Mae and Freddie Mac on their preferred stock, which the federal government declined to back even though investors clearly perceived those securities as being quasi-sovereign risk. (In what amounts to one of the most foolish decisions in financial history, those payments amounted to a measly $6 billion.) Lehman was caught with too much inventory of mortgages and other long-term securities including the agency paper that were in the process of being structured into CDOs precisely at the moment when demand for these structured products collapsed. For such a sophisticated broker to be caught with their trousers down still seems surprising. My colleague at lunch attributed Lehman's massive miscalculation to a "Goldman culture", namely the unspoken pressure to match Goldman's performance by using whatever leverage it took to do so. For example, Lehman's CEO Richard Fuld repeatedly would tell his economists and strategists that they were too optimistic and yet made no effort to translate his pessimism into restraints on leverage despite the warnings from their very competent risk managers.

The lesson is that financial institutions can become addicted to leverage and they become convinced that the deluge with not occur on their watch. China's banks seem to be headed in that direction with WMP and to date the PBOC has acted as a facilitator to their addiction. Although I believe the PBOC is committed to winding down shadow banking with the full support of the Communist Party, unfortunately officials have little or no experience in how to do so. The state banks probably are pleading for more liquidity to feed their addictions and are claiming dire consequences if they do not get their 'fix'. So Pettis undoubtedly is correct that we will see repeated recurrences of liquidity crises in China. The key question is whether the PBOC can manage these crises with administrative means without a Lehman moment. Although I am skeptical about a soft landing, one thing is certain: if China is to retain its huge surplus of saving, banks will need to offer higher deposit rates to keep the money at home. That would mean lower bank margins, just as winding down WMP will hurt profits as well. The state banks will not overcome their addiction to leverage and cheap deposits easily, so the discipline must come from the top down.

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