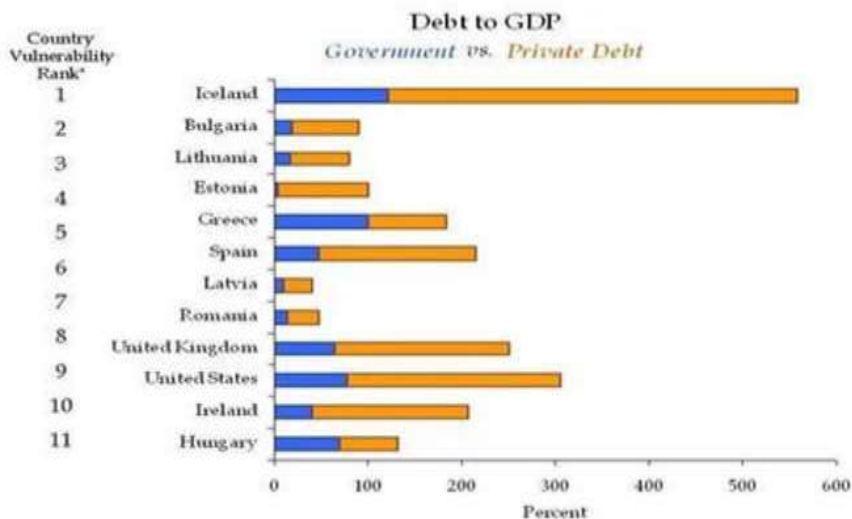


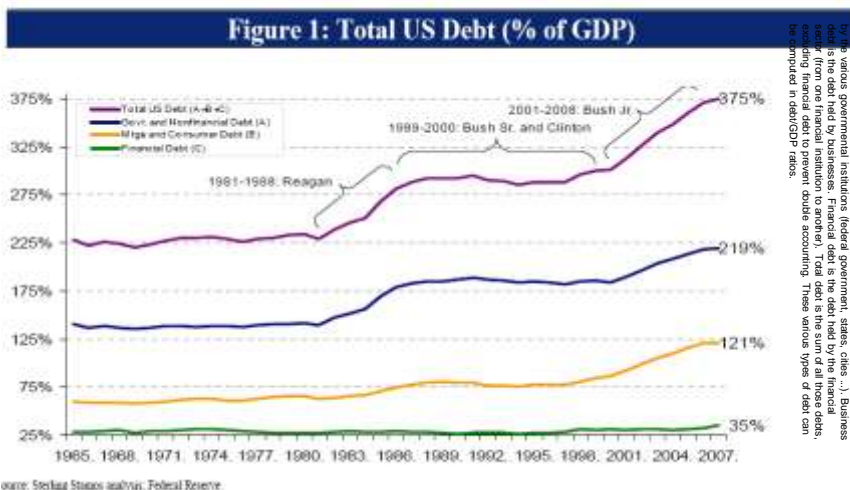
The global debt crisis and China's macro situation

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This time is different: not an ordinary crisis, but a global debt crisis



The high household debt caused the crisis: 17 percent vis-à-vis 100 percent



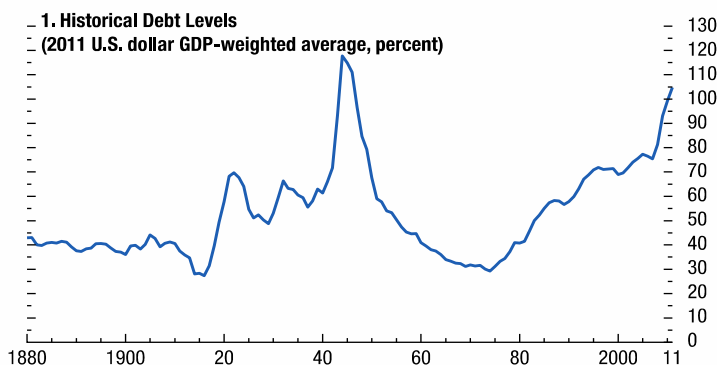
In national accounting, debts are added according to those who are indebted. In the case of the US, the debt held by various government institutions (federal government, states, cities...), business entities (from one financial institution to another), Total debt is the sum of these debts, including financial debt to prevent double accounting. These various types of debt can be compared in debt/GDP ratios.

3

From subprime crisis to public debt crisis



US Gross debt/GDP:115%



Gross public debt as a percent of GDP among advanced economies has reached historical highs: Japan, the United States, and many European countries currently have debt-to-GDP ratios close to or above 100 percent.

Without lowering the debt/GDP ratio to a sustainable level, there will be no real economic recovery, but

Throughout history, debt/GDP ratios have been reduced by:

- (i) economic growth;**
- (ii) fiscal adjustment/austerity;**
- (iii) explicit default or restructuring;**
- (iv) a sudden surprise burst in inflation; and**
- (v) a steady dosage of financial repression that is accompanied by an equally steady dosage of inflation.**

(vi) Dollar devaluation

Objectives of QEs

- **To raise asset prices by driving investors away from Treasuries**
- **To create inflation**
- **To push down the value of dollars**
- **The Fed has been successful in the three objectives, to a certain extent, but far from enough**
- **Essentially, the policy is to shift the debt burden from borrowers to creditors**

The unfavorable external environment facing China

- Weak demand for Chinese exports for a long-period of time
- China will continue to face RMB appreciation pressure, even though China's current account is more or less balanced
- China will continue to suffer from capital losses, due to US treasuries' negative real returns and US attempt to inflate away its debt burden

China has already borne large losses

- By running current account surplus and capital account surplus, China has accumulated **\$4.7 trillion** foreign assets (most of these assets are US government securities)
- By running capital account surplus, China has accumulated more than **\$2.9 trillion** foreign liabilities
- China has a positive net International investment position (NIIP), namely **net foreign assets** of **\$1.8 trillion** (as of Feb. 2012), hence China should run positive investment income. If interest rate is 3%, China should receive **\$500 billion** a year as interests (or dividends)
- But in most years, China's investment incomes were negative. In 2011, China's investment income was **-\$27billion (against \$500 billion)**

Challenges facing China

- To maintain a growth rate above 7%, China has to depend more on domestic demand
- To reduce capital losses due to the Fed's money printing, China has to stop further accumulating foreign exchange reserves by running current and capital account surpluses
- In my view, China should run trade surplus, so that to get rid off the devaluating green backs

China's short-run growth prospect

- Early this year, consensus view on growth in 2012 was 8.5%
- But the performance until recently was disappointing
- Why?
 1. The direct and indirect impacts of the fall in growth of real estate investment on the economy is stronger than expected.
 2. The European debt crisis has been worse than expected
 3. The government did not use very expansionary fiscal and monetary policy to stimulate the economy
- There was no hard landing, as we argued repeatedly since late last year
- There will be no hard landing in the near future

is foreign pundits' worry about Hard landing warranted?

- three issues driving the China hard landing narrative
 1. Over-investment
 2. the loan quality of the banking system
 3. the property bubble and the crash of the housing market

The talk of the town

- Hard landing or soft landing?
- three issues driving the China hard landing narrative
 - Over-investment
 - the loan quality of the banking system
 - the property bubble and the crash of the housing market
- My key message here is that the Chinese economy is OK, at least **for the time being**.

Over-investment

- Roubini
 - "There is a meaningful probability of a hard landing in China after 2013,"
 - "The brand new high-speed train is half-empty and the brand new station is three-quarters empty. Parallel to that train line, there is also a new highway that looked three-quarters empty. " "There is no rationale for a country at that level of economic development to have not just duplication but triplication of those infrastructure projects." **Mon June 13, 2011**
- My view
 - China's investment-driven growth is not sustainable. The investment rate cannot increase forever. Overcapacity will surface and correction is inevitable. **Snape Lecture Nov 25 2009**
 - **what is the logical behind the proposition?**
- **Caveat:** The problem is: nobody knows when the correction will happen and with what fashion. In the 80s, 90s and 2000s there are many occasions when we feared that a dramatic correction will happen, but each time, China muddled through Godrn Zhang

The loan quality of the banking system

- LFPs
 - Total borrowing of LFPs amounts to 10.7 trillion Yuan, among which 79.1% was bank loans.
 - LFP debts are largely performing
 - for the majority of the local finance platforms (LFPs), the cash flow generated by investment is still able to meet repayment of principal and interests. Majority of loans are repaid regularly
 - The non-performing ratio (NPL) is still low so far. 3%?5%? (Jan.8 2012)
- Big project finance
 - The ministry of railway: liability=1.7 trillion yuan, 4.3% of GDP
- Enterprises' high indebtedness and low profitability
 - Debt ratio (2011):107% (CASS), rising fast
 - Growth of industrial profits fell from 28.3% in the first half of 2011 to -2.7% over the same period in 2012; from Jan to Jul, total losses were 420 billion yuan, a 64.4% increase y/y
 - Bankruptcy incidences have increased significantly
- Financial innovation
 - high returns of new products such as wealth management products and trust products, how the returns can be supported by poor enterprises profitability?
- But China's overall fiscal position is still strong
 - China has experienced worse situation before, when the NPL ratio was much higher and capital adequacy was much lower. But it muddled through. The key was China's strong fiscal position
 - LFP, central government debt, and policy loans were 27% , 20% and 6% of GDP, respectively, China's total public debt-to-GDP ratio was just above 53% of GDP. The key is whether the government can foot the bill. It is still affordable for China to waste its money at least for one more

Collapse of housing market?

- the **real demand** for houses will still be strong after the withdrawal of speculative. A **floor for housing prices** will be set
- Quality of mortgages (very high down payments, very low delinquency and default, no securitization)
- Banks are in a position to absorb a large impact
- The real issue (rather than real estate bubble): **resource allocation**
 - most important contributing factor to growth growth. real estate investment-to-GDP, compared with Japan and Korea (Jan. 08, 2012, New Yorks Stock Exchange)

But we have underestimated the depth of the slowdown since 2011

- Early this year, consensus view on growth in 2012 was 8.5%
- But the performance since the second quarter has been disappointing
- Why?
 - The direct and indirect impacts of the fall in growth of real estate investment on the economy is stronger than expected.
 - The European debt crisis has been worse than expected
- How to see the slowdown
 - Good or bad? failure or achievement? Demand side or supply side?
- How to respond?
 - Another stimulus package, loosen monetary policy?
 - Stay put, continue the policies aimed at restructuring initiated in 2010-11?

Some slowdown is inevitable

- In order to achieve sustainable development, the Chinese government has to shift the priority from growth to transforming the economic development pattern and restructuring the economy. To do so, a slowdown of growth is a price China has to pay.
- Resources must be reallocated
 - real estate investment accounts for 10 % of GDP: 48 sq. vis-à-vis 90 sq.
 - Steel products account for 48 percent of world total, with hundreds of steel mills. Overcapacity is serious. You cannot absorb the excess capacity by building more steel mills.
 - Some exporting enterprises go bankrupted as a result of RMB appreciation
 - In 2011, old age population (>60) 2.5million, the number of beds in old people's homes: 7 thousands
- At micro and industrial levels, more reforms are needed

Is the government unnerved?

- Hopefully not. But
- monetary policy has been loosened
 - Injection more liquidity by selling more CBBs
 - **In the last week of September, PBOC injected 365 billion yuan into circulation by OMOs, a record for the injection in a week.**
 - Cutting reserve requirement ratio
 - On May 14, PBOC cut banks' reserve requirements a third time since November 2011, reducing the ratio to 20 percent for large banks and 18 percent for smaller institutions. More cuts will come?
- Relax loan-to-deposit ratio regulations
- Lowering benchmark lending and deposit rates twice since late last year symmetrically or asymmetrically
- **The approvals by NDRC for 7trillion yuan new projects are regarded as a signal for the loosening**, though the true intention of NDRC was another story
- Would the achievement in adjustment be rolled back? This is an open question.

The Chinese government should stay the course, while not barring fine tuning

- Personally, I think it is not necessary to introduce another stimulus package, because China's employment situation is good. The economy has over-fulfilled its implicit target of job creation
- **Its affordable**: Labor shortage rather than unemployment is a problem
- **Its desirable**: A tight economic condition will force enterprises to speed up adjustment; competition will be heavier; motivation for innovation and creation will be stronger. In short, **the supply side of economy** will be improved
- The economy has started stabilizing, even without further loosening. During October long holiday there were 450 million holiday makes and consumer expenditures in hotel and restaurant services reached to 800 billion yuan an increase of **15%** over the last year's long holiday. **Does it look like an economy heading to hard landing?**
- But the long term impact of the loosening is worrying. Structural adjustment and shift of growth pattern should not be delayed once again.

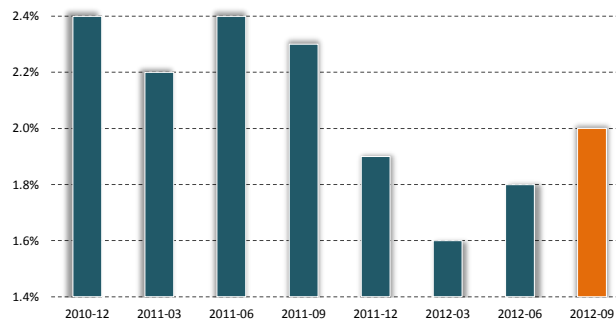
Actually, some progress has been made in structural adjustment

- **Slowdown in Investment:** The growth rate of investment in real-estate development plummeted by 16.3 percentage points year on year in the first half of 2012
- **Increase in household incomes:** plentiful anecdotal evidences indicate that growth of household disposable incomes has accelerated
- **Improvement in social security system :** The number of people covered by basic old-age insurance, unemployment insurance, workers' compensation, and maternity insurance has risen substantially. Moreover, universal medical insurance is emerging, and a comprehensive system for providing aid to students from poor families has been established.
- **Decrease in external imbalances:** since 2005, the RMB has appreciated roughly by 30% in real terms, which must have had a serious impact on exporters, reflected in the bankruptcy – as well as the upgrading – of many enterprises in coastal areas.
- **More balanced development across regions:** while growth in coastal areas has slow downed, provinces in Middle and West of China have maintained double-digit growth. Labor-intensive industries in coastal areas are moving inland. The regional disparity in economic development is narrowing.

China's growth in the rest of the year

- Though the growth rate so far was worse than expected, the growth rate will not be far below the 8% mark
- This is mainly because
 - The economy has bottomed out
 - China it has loosened monetary policy and demand for credits is strong
 - Base effect will be important in the last quarter of the year

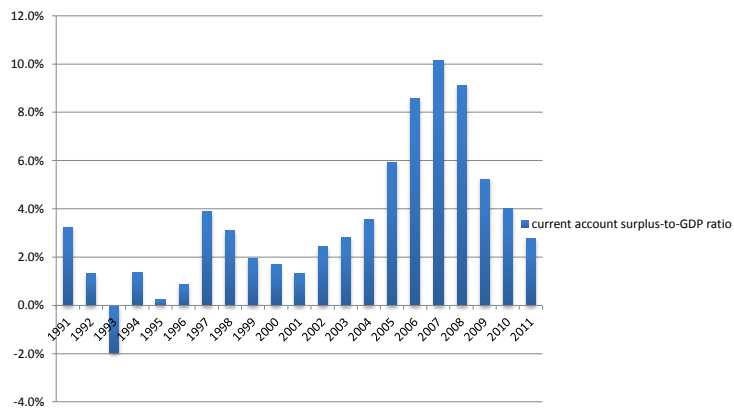
Sequential monthly growth rate



The most recent development

- The growth rate in the third quarter is 7.4%, lower than 7.6% in the second quarter
- However, the sequential growth rate in the third quarter is 9.1%, higher than 7.4% in the second quarter
- It is almost certain that the economy has bottomed out

China's rebalancing: Rapid falling of current account surplus-to-GDP ratio



From 10% to 2.8%, behind Germany now

Factors contributing to the rebalancing

- Worsening the external environment
- Worsening the terms of trade
- Domestic stimulus package
- RMB appreciation
- China's rebalancing is both cyclical and structural

Double digit falls in imports in August came mainly from energy, metal and mineral products
(2012-August)

废铜	-10.3	-17.6	-22.9	-3.2	-13.6	4.2	58.8	-32.3
未镀涂的铜及铜材	-12.2	1.9	8.3	47.1	28.1	34.4	76.3	-2.3
铝材	-14.4	-15.2	-13.3	9.3	-1.9	9.1	54.4	-25.6
木质薄板制胶合板	-14.4	-10.1	-16.2	-2.3	26.7	14.3	43.7	-26.6
铜材	-18.1	-14.1	-16.9	-9.4	-21.9	-20.1	24.5	-37.9
合成橡胶	-19.7	2.4	6.2	7.7	4.8	-5.0	48.7	-16.6
原油	-20.5	1.4	11.0	23.1	16.8	26.2	44.3	31.3
铁矿砂及其精矿	-20.9	-17.4	-5.4	1.2	-5.6	-9.1	14.6	-22.5
纺织用合成纤维	-20.9	-21.5	-23.4	-16.0	-8.9	3.8	82.2	-29.3
纸浆	-22.7	-1.2	14.1	-6.3	-9.4	-0.2	15.2	-31.9
原木	-25.6	-21.8	-20.3	-10.8	-2.3	-3.6	46.9	-20.3
天然橡胶	-30.3	-5.1	12.2	7.6	-30.3	-35.7	-4.0	-29.1
成品油	-37.2	-3.0	-16.8	5.6	-2.9	14.8	47.7	-6.8
铜坯及铜铸件	-38.1	-5.4	-28.6	-8.1	-18.9	-24.0	37.4	-56.0
聚酯切片	-38.6	-4.0	0.5	17.1	-1.4	-4.9	72.0	-3.9

The trends of the RMB

- The room for the RMB to appreciate is no longer large
- The pcbc may further reduce intervention in the foreign exchange market
- Due to RMB internationalization, China has de facto opened the short-run cross-border capital flows
- The capital account will have increasingly large impact on the RMB exchange rate. The RMB exchange rate will become more variable.

Concluding remarks

- The fundamental cause of the global financial crisis is over-indebtedness of developed countries
- The global deleveraging is the only solution for the global financial crisis
- The deleveraging will take long-time and so will be global growth
- For the US, export growth hold the key for recovery
- To achieve export growth, the US dollar has to be further devaluated, which in turn dependent on the Fed's money printing

Concluding remarks

- 2012 is a difficult year for China, but there will be no hard landing, government will and can prevent hard landing from happening. **The true danger lies in the medium run.**
- The Chinese government has to strike a balance between rebalancing the economy and maintaining a slower but still decent growth rate
- The bigger danger is that the fear of a slowdown leads to rolling back the measures aimed at readjustment, as a result of an over loosening
- The longer is the delay in restructuring and rebalancing, the higher the cost will be

continued

- Certainly, the slowdown is not painless. The Chinese government has to deal with numerous social and economic contradictions head on, many of which will surface or resurface as a result of the slowdown of economic growth. However, the government should not be unnerved by the slowdown. It should stay the course.
- In my view, China has entered a new period of adjustment and paradigm shift, which may last for several years. During this period, the Chinese economy will grow at a range of 7-8 percent. Thereafter, growth will pick up again and eventually lift China up to a new plateau of a high-income country.