Chinese economy's 5 risks which could affect Vietnam and the world

It is a known fact that the Chinese economy is changing its development model. However, there are new developments occurring in the world's second biggest economy, which could have a (negative) influence on the whole globe.

> 2000: The dot-com bubble will remain high-tech sector's issue.
>
> 2007: The mortgage crisis will remain banking sector's problem.
>
> 2012: Greek debt restructuring will remain Greek trouble.
>
> 2016: The Chinese economic transition will remain a Chinese issue.

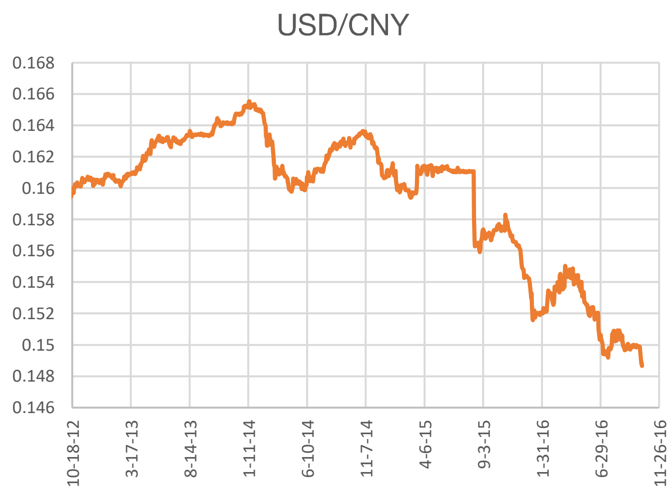
These statements were mentioned by renowned economists and analysts during the times of generally positive economic developments. However, we know what turned out in the years after:

> 2001: One of the longest lasting stock market declines, followed by a recession
>
> 2008: Global financial crisis, followed by the hardest recession since World War II
>
> 2012: A time of sluggish economic development in most parts of the EU
>
> 2017: ?

Even if the status of the Chinese economy is much better than often perceived, there are risks which should not be neglected. Due to its size and purchasing power, China has become a pillar of stability for the region and the global economy. We are discussing 5 of the main risks and their potential effects on the world and Vietnam in particular.

Risk 1: Strong capital outflows and currency losses

According to data by Bloomberg, capital withdrawals form the Chinese Yuan (CNY) accumulated to $27.7 billion in one month, whereas the average of the past 5 years was around $4.4 billion. These payment streams are a sign for a lot of insecurity of investors and even the local people towards the future economic development. Shrinking availability of capital will sooner or later lead to a reduction of investments and thus a potential acceleration of economic downturn CNY has devaluated by around 9% since its temporary high in January 2014.



Source: http://fx.sauder.ubc.ca/

Potential effects on Vietnam

Over the past years, Vietnam has been one of the big winners of Chinese investment outflows as many companies moved their factories from the northern neighbor. With low exchange rates of the CNY and a strong increases of Vietnamese wages, one of Vietnam´s competitive advantages, low labor costs, is vanishing. FDI inflows will roughly reach the same levels as last year. However, the main drivers for this development, rising production costs in China and the Trans Pacific Partnership (TPP), are gone for the moment.

Potential effects on the rest of the world

According to October 2015 data by the International Monetary Fund, more than 40% of the world's GDP growth was comprised of the growth in China. If the capital outflows and currency devaluation continue in the months ahead, the impact on the world economy will no longer be neglected.

Risk 2: Overall indebtedness

China's high debts present a serious problem.

The total debt (foreign and domestic borrowing) in relation to GDP rose from 148% in 2007 to 237% at the end of Q1 2016. "Every major country with a rapid increase in debt has experienced either a financial crisis or a prolonged slowdown in GDP growth," Ha Jiming, Goldman Sachs chief investment strategist, wrote in a report this year.

It can be argued that such high debt levels can be acceptable in a booming economy. However, the growth is fueled by adding ever more debts (e.g. the debt level grew faster than GDP). Bad debts raise the concern of a financial crisis which would spread across the region and into the entire world. In 2012, only 7 years after their IPO, Goldman Sachs withdrew their stake in ICBC bank. By that time the shares had added around $7 billion value.

Goldman Sachs is famous for not making bad deals. Oftentimes, the bank sees trends long before the others. For example, before the US-subprime crisis broke out in 2007/2008, Goldman Sachs had already shorted its positions and was one of the few institutions which turned out stronger than before the crisis. Which reason did they have to sell their share in ICBC at a time when it was traded far below their maximum levels? The investment bank probably smelt smoke. Let´s hope it was a false alarm.

Potential effects on Vietnam

Like in many other countries in the world, China has poured a lot of money into Vietnam. There are a lot of Chinese investors behind some of the major housing projects. China is also Vietnam's biggest trading partner. Should one of the worst case scenarios for the Chinese economy happen, and a financial crisis breaks out, it would be likely that Chinese investors around the world would need to sell their assets to cover their debts. While we do not exactly know what this would mean for Vietnam, we can be certain that the country would not remain unaffected.

Potential effects on the rest of the world

If there were a financial crisis as suspected by the Chief Investment Strategist of Goldman Sachs, it would depend on the severity of the crisis to know how much it would affect the global economy. We would predict that the sheer amount of debts would cause substantial risks for the entire world and could potentially dwarf the subprime crisis.

Risk 3: Asset price inflation

Cheap and abundant money is likely to stimulate an economy. By changing availability and price, central banks all over the world try to influence the economic cycles: they try to temper economic growth by reducing availability of money and increasing interest rates. Vice-versa, they try boosting sluggish economic growth by lowering interest rates and increasing availability of money. The additional money can either be invested as productive loans which are used by companies to provide more or better services to the economy or unproductive loans which are used to buy property and other assets, or for consumption. It is often argued by many economists that banking laws encourage borrowers to invest in non-productive loans, which causes asset prices to rise to unhealthy levels (cf. Richard A. Werner).

In China, such an asset price inflation has been seen in the years during and after the global economic crisis in 2008 and the years after, when house prices in the big cities exploded. For example, the Shanghai housing prices tripled in only 12 years. Hence, it can be argued that the additional money was in a large part invested in non-productive loans than in new machines, services or new businesses.

Asset price inflation does not necessarily need to signify a risk. However, soaring asset prices can be indicators for price bubbles such as the ones we have seen in the US-property market before the financial crisis. If asset prices start decreasing, investors or property owners might need to deposit further assets to secure loans or sell their property to cover their credits which would after all lead to further price reductions. Such a loss of wealth can either add bad debts to the banking system and lead to systemic banking risks or have a direct negative impact on spending of consumers and thus the overall economic development. The impact of a potential Chinese asset bubble on the Vietnamese and the world economy are thus the same.

Potential effects on Vietnam and the world

Should the soaring prices in the property market be the result of an asset bubble (which is not sure, but possible) the risk of a bubble burst would be existing. A sharp decline in the Chinese property market will likely slow down the Chinese economy and ultimately slow global demand. States which have over-stretched their budget in the past decades would need to react with austerity measures which would cause further economic downturns worldwide. Since China has become the second biggest economy, such a scenario is no longer unrealistic today. However the worst-case scenario is currently not very likely since the government in China has a lot of control over the property market and would intervene fast. Still, we believe that it is important for people around the world to understand the interdependencies of the world’s economies and observe carefully the asset price developments in China.

4. Non-performing loans

According to Reuters’ July 2016 data, the level of non-performing loans (NPLs) in the Chinese banking sector reached $300 billion, or 2.15% of the total loan portfolio. Many analysts believe that the unofficial numbers could be even higher. $300 billion of bank assets are at risk with a rising trend. Does this number seem familiar to you? We might tell you why: $300 billion is almost the amount of Greek government’s debt by the end of 2015. Of course, comparing the Chinese banking system to Greece is a nuisance. However, it provides an impression of the sheer size of the challenges arising from NPLs in two world’s second economy. The statistics further indicate that the NPL ratio has risen by 0.16 percentage points in only one month with an upward trend. In a trial to get off bad loans, Agricultural Bank of China recently announced to offload $1.6 billion of bad debts to sell them on the market in the form of asset backed securities. Only several days later, they announced to raise their capital by as much as $12 billion within three years. Both actions can be good signs showing that Chinese banks are trying to implement counter-measures before the challenges become a problem. However, the rising figure of bad debts in the system are a clear sign that the times of easily earning money with any business in China are over. Failure in the Chinese market has become more likely.

Potential effects on Vietnam

If bad debts rise further, Chinese investors might need to withdraw their overseas investments to pay off domestic loans. China is a big investor in Vietnam, with a total of $56.7 billion worth of FDI. With capital requirements in China being on the rise, banks in the region might focus on stabilizing the Asian banking system. Vietnamese banks have offloaded a large amount of NPLs in the past years, however, are poorly capitalized. Banking restructuring in the entire region could also slow down the Vietnamese economy, while investment withdrawals from Chinese investors would have a direct negative impact on Vietnam’s GDP growth.

Potential effects on the rest of the world

China is no longer as dependent on FDI inflows as a decade ago. The country is transforming into a consumer-oriented economy and its companies have grown to sizes which allow them to make significant investments and mergers abroad. Kuka in Germany, Syngenta in Switzerland, or Supercell in Finland are just some well-known examples of these recent developments. With rising debt levels in the banking system, banks might become more restrictive when it comes to financing such projects. Patriots might be happy, while declining China investments might result in a sluggish global economy.

Risk 5: Fragile overall macroeconomic environment

How would central banks react if Lehman Brothers failed today?

The global financial crisis was followed by a period of subdue economic development in many parts of the world. Growth rates have thus far not been high enough for central banks to increase interest levels to a more healthy level. In Europe and Japan, fiscal policies have never been more expansive than today. Global economy is on a fragile ground even 8 years after Lehman Brothers collapsed. As stated in the first chapter, China has accounted for more than 40% of global economic growth in the past years. Therefore, all eyes are on China when it comes to the outlook for the entire world. Western countries might need to find alternative approaches to fight slow growth while giving China time to restructure their own economy. Currently, markets around the world react and sometimes over-react on good or bad data from China. It was predictable that sooner or later double digit growth rates would need to fall to lower levels. We believe that there is a risk that China and the world could face a hard landing if all the hopes for global economic development only lie on China. Europe and the US will have to find solutions for their current challenges themselves.

Author: Manuel Wendle, BDG Vietnam

December, 2016

BDG Vietnam

Tel. +84 8 3823 7859
Email: contact@bdg-vietnam.com
For additional information and publications, please visit our webpage: bdg-vietnam.com