QNB Economics
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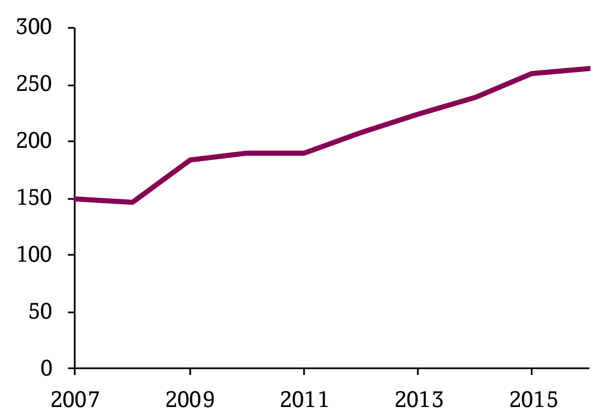
China remains the biggest threat to global financial stability

In late-August, the heads of the world's major central banks gathered at the Jackson Hole Symposium in Wyoming, an annual forum for global economic policymakers and academics. Attracting the most attention at this year's symposium was the discussion on financial stability – the ability of the financial system to manage and absorb shocks and prevent major crises from emerging. While the focus of the Jackson Hole debate was on the US, there are also important financial stability risks emanating from Europe and China. We survey the financial stability risks across these jurisdictions and conclude that although no crisis seems imminent, China remains the biggest threat to global financial stability.

In the US, the concern around financial stability reflects elevated equity prices, which are stretching fundamentals, and high corporate leverage. US equity prices have risen dramatically since the election, spurred on by President Trump's proposed fiscal stimulus. The fiscal stimulus was planned to be implemented through corporate tax cuts and a large infrastructure spending programme which would benefit certain sectors, such as health, materials and transportation. However, should the fiscal stimulus not materialise or be reduced in magnitude, earnings prospects for the affected industries might not justify their current valuations and cause share price corrections. Meanwhile, corporate leverage has risen substantially in recent years but firms' earnings have not gained proportionately, resulting in higher debt servicing burdens. Faster-than-expected monetary tightening could further stretch corporate debt servicing burdens, risking defaults and creating stress in corporate credit markets. Potentially exacerbating both challenges is the Trump administration's plans to loosen financial regulations, which includes allowing more risky lending and permitting banks to trade on their own behalf and not strictly for clients – the so-called Volcker Rule.

The challenge in Europe is the continent's troubled banks. There is an overconcentration of European banks and legacy of bad loans, particularly in Portugal, Italy, Ireland and Greece. Essentially, there have been too many banks chasing after a limited pool of profitable lending opportunities, which has led to excessive risk taking. The result has been weak profitability which has hampered banks' ability to build stronger buffers and has increased their vulnerability to failure in the event of an economic shock. Moreover, a lack of a common depositor insurance scheme amongst Euro Area countries and complex fiscal rules relating to bank bailouts, limit the manoeuvrability of policymakers to resolve bank failures.

China total debt
(% of GDP)



Sources: Bank of International Settlements and QNB Economics

China's issue is its massive debt burden. Debt in China is over 250% of GDP and largely held by state owned entities (SOEs). The crux of the issue is that growth has been driven by rapidly expanding credit to SOEs in targeted sectors such as real estate and industrials, but now these sectors are plagued by massive excess capacity. Authorities therefore face the challenge of gradually unwinding large non-performing loans without causing a collapse in growth.

So, why does China pose the biggest risk to global financial stability? There are three main reasons. First, the scale of its challenge is much bigger considering that it encompasses almost three times the size of its economy. Second, its outsized role in global trade means it would propagate a crisis to the rest of the global economy rapidly. Third, compliance with post-crisis financial regulation is much higher in the US and Europe than in China.

In short, despite the focus on the US, financial stability risks are most elevated in China. While it does not appear that such risks are imminent, the threat of a financial crisis from China would be massive shock to the global economy.

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