Mizuho Brief: China Risks

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MIZUHO

China Woes (Part 2): Liquidity Trap?

- Beijing's **efforts to pump-prime away spill-over property sector risks** hitting wider financial markets may be **frustrated by** a pernicious iteration of **"liquidity trap"**.
- Fairly **severe confidence deficit** appears to be **impeding the intended liquidity cushion** as the *"flow" of liquidity stimulus* is *impeded* (and stimulus pools).
- **At the heart of deficient "animal spirits"** are **adverse feedback loops** from *balance sheet* and *cash-flow vulnerabilities* that threaten **debilitating shocks** to the financial system; with real economic spill-over.
- **Especially given** the **inextricable linkages across sectors**, incited by property risk spill-over that ***accentuates cross-default risks;*** **amplifying threats of contagion**.
- Above all, the **property sector** already facing a **solvency crisis means** that **liquidity backstops may prove "too little, too late"**; and not just for property sector distress.
- The non-interchangeability of credit and confidence (requiring confidence to spur productive credit growth) is reflected in distinction of net revenues *required to avert a solvency crisis,* versus less effective "after-the-fact" **banking liquidity** backstops.
- **Dauntingly high bar for ensuring financial stability** as a minimum may **entail much steeper fiscal cost** given painfully sharp capital-, macro- and CNH-stability trade-offs involved with monetary stimulus.

Liquidity Trap Frustrating Pump-priming

China may be facing its **most challenging version of a liquidity trap yet**. Especially **as it tries**, with considerably greater difficulty, **to pump-prime its way out of adverse balance sheet and cash-flow shocks**; much of which was self-inflicted from brutal property sector crackdowns earlier.

The danger is, that **pump-priming efforts may be frustrated** by *binding confidence deficit impediments,* and not merely "zero-bound" limitations, that result in a "liquidity trap".

Pooling, Not Flowing

By definition, "liquidity trap" results from **monetary stimulus that "pools" but fails to flow**; with consequently impeded growth multipliers (from restrained credit creation) denying a self-sustaining recovery.

This underscores our **misgivings about the efficacy of selective pump-priming** comprising recent (albeit measured) rate cuts and liquidity infusion. Which merely constitutes *signalling response, not necessarily adequate resolution.*

Adverse Stock-Flow Feedback Loop

Especially **in the context of adverse balance sheet (stock) and cash-flow (flow) shocks** that *elevate uncertainty* and *hobble confidence;* inevitably accentuating the tyranny of a "liquidity trap" that impedes policy stimulus. The **threat of adverse feedback loops is reflected in the dire state of**;

i) *Country Garden,* one of China's largest private sector developer formerly touted to be a "survivor in the private sector property developer purge, *teetering on the brink of defaults* juxtaposed against;

ii) *Zhongrong,* one of China's top ten shadow banks, *missing payments on wealth management products* (WMP) related to trust loans made out to the property sector on account of short-term liquidity crunch.

Contagion Risks

To be sure, this is not undue fuss about specific firm defaults, but **justifiable concern about potential for**

a financial contagion.

Point being, **Country Garden and Zhongrong are neither one-off nor unrelated occurrences**. To the contrary, they are *inextricably linked via credit and cash-flow channels;* replete with **adverse feedback loops**. In particular, **between balance sheet/cash-flow shocks set off by property sector** travails, **the WMP industry**, (with more than 10% exposure to developer loans) and **households.**

Cross Defaults

What's more, **inter-dependence**, and **inextricable economic/financial linkages, run much deeper and wider**; across the property, construction, wider ancillary goods/services, shadow-banking, banking and household sectors. Inevitably, this **accentuates vulnerabilities to cross-defaults** from any shock – be it to cash-flows and/or the balance sheet – and regardless of its point of origin.

Accentuated by Solvency Crisis

Crucially, the **amplification of contagion risks** *that follows accentuated vulnerabilities to cross defaults* **is exacerbated by on-going solvency crisis in the property sector**. As a result of which, the ability of policy pump-priming aimed at arresting the liquidity crunch may be inadvertently impaired.

Put differently, **merely flushing liquidity** (direct supply infusion or via price/rate cuts) **may not be effective in resolving a solvency crisis already underway**; unlike a "before-the-fact" liquidity life-lines meant to prevent a cash crunch from turning into a solvency crisis.

(Limitations of) Kicking Cans

More pointedly, **liquidity backstops to tide over duration mismatch merely kicks the can down the road** (possibly a very short one) ***if solvency issues are unresolved***.

Simply put, **liquidity provisions** (effectively financing cash-flows) for beleaguered, highly indebted and bleeding property developers **cannot overcome chronic shortfall in net revenue** (operating cash-flows). *Nor can liquidity relief for downstream* (be it shadow banks or LGFVs*) *property-induced stress.*

More Pernicious "Liquidity Trap"

The upshot is that **China's current iteration of "liquidity trap" appears more pernicious** than the garden variety. For it is **not merely the inability to stoke demand-side recovery**, but more worryingly, the ***possible failure to ensure financial and macro stability****;* which is a **pre-condition to avoid worse-case recession scenarios**.

Non-Interchangeability

All said, the PBoC's **liquidity response** to spots of distress (e.g. in trust companies/shadow banks and anywhere else) **risks falling woefully short**. Why?

In a word, **non-interchangeability**; as it applies to liquidity and revenues as well as confidence and credit. Trying to substitute one for the other doesn't always work. Not as quickly or painlessly anyway.

Solvency Distinction

Contrary to misconceptions of fungibility of money, **bank liquidity** (financing cash-flows) **is not interchangeable with net revenues** ("operating cash-flows") **required to remain solvent**. And insofar that *liquidity infusion cannot surmount a solvency crisis,* a "**liquidity trap" of sorts will frustrate**.

Confidence Horse, Credit Cart?

Especially **when credit provision cannot make good confidence deficit**. The two are not substitutable, and **one doesn't guarantee the other**; despite the correlation between the two.

In particular, in the current climate, it is misguided to think credit is the horse driving the confidence cart. Instead, confidence is likely (the horse) to be the pre-requisite for invoking a productive credit cycle.

Higher Bars

And so, with such a high risk associated with "liquidity trap", **the bar is dauntingly high** for Beijing; **to** not just lift the economy out of a rut; but as a minimum **ensure that an inadvertent financial crisis is averted**. **Given sharper trade-offs involving of capital outflow, macro- and CNH stability risks** from monetary stimulus, a **much higher fiscal cost might have to be incurred**.